Pat 166 85796 U. S. S. C.

TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1937

No. 446

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

ELBE OIL LAND DEVELOPMENT COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

PETITION FOR CERTIORARI FILED SEPTEMBER 21, 1937

CERTIORARI GRANTED NOVEMBER 8, 1937

No. 8358

United States

Circuit Court of Appeals

For the Ninth Circuit.

ELBE OIL LAND DEVELOPMENT COMPANY,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Transcript of the Record

Upon Petition to Review an Order of the United States Board of Tax Appeals.

Parker Printing Company, 545 Sansome Street, San Francisco

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1937

No. 446

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

ELBE OIL LAND DEVELOPMENT COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

INDEX

	Page
Proceedings before United States Board of Tax Appeals	1
Docket entries, No. 54773	1
Docket entries, No. 60157	4
Petition, No. 54773	6
Exhibit—Notice of deficiency	28
Answer, No. 54773	24
Petition, No. 60157	25
Exhibit—Notice of deficiency	28
Answer, No. 60157	32
Stipulation of facts	34
Exhibit A—Agreement between Elbe Oil Co. and Honolulu Oil Co., Oct. 8, 1927	37
Stipulation re exhibits B and C, No. 54773	65
Exhibit B—Map of Round Mountain oil field	66
Exhibit C—Schedule showing wells drilled by Honolulu Co. etc	67
Opinion, Tyson, M	69
Decision	76
Petition for review and assignments of error	77
Praecipe for record	83
Clerk's certificate	85
Proceedings in U. S. C. C. A., Ninth Circuit	86
Order of submission	86

	Page
Order directing filing of opinions and judgment	86
Opinion, Wilber, J	86
Concurring opinion, Haney, J	90
Dissenting opinion, Garrecht, J	90
Judgment	91
Clerk's certificate	91
Order allowing certiorari	92

APPEARANCES:

For Taxpayer:

W. L. E. O'BRYAN, Esq.,
FRED R. ANGEVINE, Esq.,
GEORGE T. ALTMAN,
C. WM. WITTMAN, Esq.

For Comm'r:

JOHN F. GREANEY, Esq.,
ELDEN McFARLAND, Esq.,
E. G. SIEVERS, Esq.

Docket No. 54773.

ELBE OIL LAND DEVELOPMENT COMPANY,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DOCKET ENTRIES.

1931

Mar. 27—Petition received and filed. Taxpayer notified. (Fee paid).

Mar. 27—Copy of petition served on General Counsel.

Apr. 28—Answer filed by General Counsel.

May 5—Copy of answer served on taxpayer. Circuit Calendar.

Oct. 6—Notice of appearance of Fred R. Angevine as counsel filed.

1933

Aug. 2—Hearing set in Long Beach, California, beginning Sept. 11, 1933.

Sept. 18—Hearing had before Mr. Marquette on merits. Submitted. Dockets 54773 and 60157 consolidated for hearing and decision. Stipulation of facts. Briefs due Nov. 22, 1933. Called Sept. 11, 1933.

Nov. 10—Motion for extension of 30 days to file brief filed by taxpayer.

Nov. 13—Motion for extension of 30 days to file brief granted to Dec. 22, 1933 as to both parties.

Nov. 22—Brief filed by General Counsel.

Dec. 15—Motion for extension of 30 days to file brief filed by taxpayer.

Dec. 15—Motion for extension of 30 days to file brief granted to Jan. 22, 1934 to both parties.

1934

Jan. 20—Supplemental brief filed by General Counsel.

Jan. 22—Motion for extension of 30 days to file brief filed by taxpayer. 1-23-34 granted to 2-21-34.

Jan. 30—Stipulation of facts filed.

Feb. 19—Brief filed by taxpayer.

1936

Apr. 14—Opinion rendered, John A. Tyson, Div. 1. Decision will be entered under Rule 50.

1936

May 6—Notice of settlement filed by General Counsel.

May 9—Hearing set May 27, 1936 on settlement. [1*]

May 27—Hearing had before Mr. Sternhagen on settlement under Rule 50. Respondent's recomputation—not contested—Referred to Mr. Tyson for decision.

May 28—Decision entered—John A. Tyson, Div. 1.

May 28—Consent to settlement filed by taxpayer.

June 2—Order vacating decision, entered.

June 2—Decision entered—John A. Tyson, Div. 1.

Aug. 25—Notice of the appearance of George T. Altman counsel for taxpayer.

Aug. 27—Petition for review by United States Circuit Court of Appeals, Ninth Circuit, with assignments of error filed by taxpayer.

Aug. 27—Proof of service filed by taxpayer.

Oct. 2—Praecipe filed.

Oct. 2—Proof of service of praecipe filed. [2]

*Page numbering appearing at the foot of page of original certified Transcript of Record.

APPEARANCES:

For Taxpayer:

W. L. E. O'BRYAN, Esq.,
GEORGE T. ALTMAN,
FRED R. ANGEVINE, Esq.,
C. WM. WITTMAN, Esq.

For Comm'r:

ELDEN McFARLAND, Esq.,
JOHN F. GREANEY, Esq.,
E. G. SIEVERS, Esq.

Docket No. 60157.

ELBE OIL LAND DEVELOPMENT COMPANY,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DOCKET ENTRIES.

1931

Oct. 9—Petition received and filed. Taxpayer notified. (Fee paid).

Oct. 12—Copy of petition served on General Counsel.

Nov. 27—Answer filed by General Counsel.

Dec. 2—Copy of answer served on taxpayer. Circuit Calendar.

1933

Aug. 2—Hearing set for week of Sept. 11, 1933, Long Beach, California.,

Sept.18—Hearing had before Mr. Marquette, Div. 1, on merits, Consol. with 54773. Briefs due Nov. 22, 1933. Called Sept. 11, 1933.

Nov. 10—Motion for 30 days additional to file briefs filed by taxpayer.

Nov. 13—Motion granted to Dec. 22, 1933 both parties.

Nov. 22—Brief filed by General Counsel.

Dec. 15—Motion for 30 days extension to file brief, filed by petitioner. 12/15/33 granted to Jan. 22, 1933 both parties.

1934

Jan. 20—Supplemental brief filed by General Counsel.

Jan. 22—Motion for 30 days extension to file brief filed by petitioner. 1/23/34 granted to 2/21/34.

1936

Apr. 14—Opinion rendered, Mr. Tyson, Div. 1. Decision will be entered under Rule 50.

May 6—Notice of settlement filed by General Counsel.

May 9—Hearing set May 27, 1936 on settlement.

May 28—Consent to settlement filed by taxpayer.

May 27—Hearing had before Mr. Sternhagen on Settlement under Rule 50. Respondent's Recomputation—not contested—Referred to Mr. Tyson for decision.

May 28—Decision entered, John A. Tyson, Div. 1.

1936

June 2—Order vacating decision entered.

June 2—Decision entered, Mr. Tyson, Div. 1.

Aug. 25—Notice of the appearance of George T. Altman filed.

Aug. 27—Petition for review by United States Circuit Court of Appeals, Ninth Circuit, with assignments of error filed by taxpayer.

Aug. 27—Proof of service filed by taxpayer.

Oct. 2—Praecipe filed.

Oct. 2—Proof of service filed. [4]

United States Board of Tax Appeals

Docket No. 54773

ELBE OIL LAND DEVELOPMENT COMPANY,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION

The above named corporation hereby appeals from the determination of the Commissioner of Internal Revenue set forth in his letter (IT:AR:E-3 TCC-60D) dated February 26, 1931, and as the basis of its appeal sets forth the following:

1. The petitioner is the Elbe Oil Land Development Company, a California corporation, whose

business address is 714 West Tenth Street, Los Angeles, California.

2. The deficiency letter, a copy of which is attached, was mailed to the petitioner on February 26, 1931 and states an alleged liability of $16,626.09.

3. The taxes in controversy are income taxes for the calendar year 1928, and are in the amount of $16,626.09. There is no tax for the calendar year 1927, the income of which is also involved.

4. The determination of tax set forth in said notice of deficiency is based upon the following errors:

(a) The respondent erred in holding the October 3, 1927 agreement with the Honolulu Consolidated Oil Company to have been a sale and not a sublease and in failing to allow the petitioner depletion on bonuses and royalties received under the terms of the agreement. [5]

(b) The respondent erred in holding that certain reimbursements for purchase of materials and supplies were income to the petitioner.

(c) The respondent erred in failing to allow as deductions from income in 1927 and 1928 certain amounts paid for traveling and other business expenses.

(d) The respondent erred in failing to allow as deductions from income in 1928 certain insurance and automobile expense.

(e) The respondent erred in failing to allow as deduction in 1928 depreciation on automobile used for business purposes.

(f) The respondent erred in failing to allow as deduction from income in 1927, depreciation on office furniture and fixtures, automobiles, and other tools and equipment owned and used by petitioner.

(g) The respondent erred in failing to recognize that the assessment and/or collection of the said alleged deficiency is barred by the relevant provisions of the Statutes of Limitation.

5. The facts upon which the petitioner relies as the basis of this proceeding are as follows:

(a) The petitioner, by reason of an agreement with the Honolulu Consolidated Oil Company, dated October 3, 1927, was the owner of a sub-lease on certain properties and by reason of this sub-lease received certain amounts in 1927 and 1928 as bonuses or royalties. These amounts are subject to depletion allowances as provided in Section 214 (a) (9) of the Revenue Act of 1926 and Sections 114 (a) (3) and Section 23 (a) of the Revenue Act of 1928.

(b) An amount of $5,178.65 was expended by the petitioner for material and supplies subsequent to October 3, 1927 on properties operated by the Honolulu Consolidated Oil Company under agreement of October 3, 1927. This amount was later reimbursed to the petitioner by the Honolulu Consolidated Oil Company. This amount is not income but should be eliminated from the cost of properties.

(c) The petitioner during the year 1927 reimbursed L. S. Barnes, its chief executive officer, for traveling expenses incurred on its behalf in [6] the amount of $14,678.51 of which the respondent has allowed only $1,578.51 as a deduction from income. In 1928 traveling expense reimbursements amounted to $5,202.56 of which the respondent was allowed only $638.05 as a deduction from income. The amounts reimbursed were legitimate expenses necessary to carry on the petitioner's business and should be allowed.

(d) The petitioner expended during the year 1928, the sum of $4,136.22 for insurance and automobile expenses. The respondent has allowed of this amount only $2,791.03 as a deduction against income. The entire amount should be allowed as they were incurred entirely in the petitioner's business.

(e) The petitioner on March 1, 1928 purchased a Lincoln automobile for $5,451.00. Depreciation for nine months at rate of 25% per annum amounted to $1,022.04.

(f) The petitioner in its income tax return for the calendar year 1927 failed to deduct depreciation on certain assets owned. Depreciation is now claimed on these assets as follows:

Asset	Cost	Rate	Depreciation
Automobiles	$3,147.40	25%	$ 786.85
Office Furniture, and Fixtures	2,600.73	10%	260.07
Machinery and Tools	4,054.50	10%	405.45
Total			$1,452.37

(g) The return of the petitioner was duly filed on May 15, 1929.

WHEREFORE, the petitioner prays that this Board may hear this proceeding and rule:

(a) That the petitioner is entitled to depletion on amounts received during the year 1928 by reason of the agreement with the Honolulu Consolidated Oil Company, dated October 3, 1927.

(b) That the amount of $5,178.65 reimbursed by the Honolulu Consolidated Oil Company is not income.

(c) That additional traveling expenses are allowable and deductible as follows: for the year 1927, $13,100.00; for the year 1928, $4,564.15. [7]

(d) That additional insurance and automobile expense of $1,345.19 is allowable and deductible for the year 1928.

(e) That additional depreciation on Lincoln Automobile purchased March 1, 1928 of $1,022.04 is allowable and deductible for the year 1928.

(f) That additional depreciation for the year 1927 in the amount of $1,452.37 is allowable and deductible.

(g) That the assessment and/or collection of any deficiency is barred by the Statutes of Limitation.

W. L. E. O'BRYAN,
Counsel for Taxpayer,
707 South Hill Street,
Los Angeles, California. [8]

State of California,
County of Los Angeles—ss:

L. S. Barnes, being duly sworn, deposes and says: that he is the Secretary and Treasurer of the Elbe Oil Land Development Company, the petitioner named in the foregoing petition, and as such is duly authorized to and does verify the foregoing petition; that he is familiar with the statements contained therein and that the facts stated are true and correct to the best of his knowledge and belief.

L. S. BARNES.

Sworn to before me this 20th day of March, 1931.
[Seal] (Signed) IRMA E. COMSTOCK,
Notary Public. My commission expires Nov. 9, 1931.
[9]

NP-2-28

TREASURY DEPARTMENT
Washington

Office of
Commissioner of Internal Revenue

Feb. 26, 1931

Address Reply to
Commissioner of Internal Revenue
and refer to

Elbe Oil Land Development Company,
714 West Tenth Street,
Los Angeles, California.

Sirs:

You are advised that the determination of your tax liability for the year(s) 1928 discloses a deficiency of $16,626.09 as shown in the statement attached.

In accordance with section 272 of the Revenue Act of 1928, notice is hereby given of the deficiency mentioned. Within sixty days (not counting Sunday as the sixtieth day) from the date of the mailing of this letter, you may petition the United States Board of Tax Appeals for a redetermination of your tax liability.

HOWEVER, IF YOU DO NOT DESIRE TO PETITION, you are requested to execute the enclosed agreement form and forward it to the Commissioner of Internal Revenue, Washington, D. C., for the attention of IT:C:P-7. The signing of this agreement will expedite the closing of your return(s) by permitting an early assessment of any deficiency and preventing the accumulation of

interest charges, since the interest period terminates thirty days after filing the enclosed agreement, or on the date assessment is made, whichever is earlier; WHEREAS IF NO AGREEMENT IS FILED, interest will accumulate to the date of assessment of the deficiency.

Respectfully,
DAVID BURNET,
Commissioner.
By (Signed) J. C. WILMER
Deputy Commissioner.

Enclosures:
Statement
Form 882
Form 870 [10]

STATEMENT

IT:AR:E-3
JCC-60D

In re: Elbe Oil Land Development Company,
714 West Tenth Street,
Los Angeles, California.

TAX LIABILITY.

Years	Corrected Tax Liability	Tax Previously Assessed	Deficiency
1927	None	None	None
1928	$40,724.67	$24,098.58	$16,626.09
Total	$40,724.67	$24,098.58	$16,626.09

Reference is made to the report of the internal revenue agent in charge, Los Angeles, California, a

copy of which was mailed to you July 5, 1929, also to your protest dated August 19, 1929.

Careful consideration has been accorded your protest in connection with the findings of the examining officer and the report on the conference with your representatives in the office of the agent in charge at Los Angeles, September 19, 1929.

On December 10, 1930 one of your representatives Mr. W. L. E. O'Bryan from the New York office of Mattison, Davey and Winters was granted a hearing in this office at which time the representative requested that a 60-day letter be issued. Since the hearing Mr. O'Bryan has submitted certain additional information which has been given careful consideration in connection with the revenue agent's report.

The issues raised in your protest are as follows:

1. Disallowance of depletion on oil and gas leases sold.

2. Disallowance of $5,178.65 representing the cost of material and supplies purchased and used in connection with leases sold to the Honolulu Consolidated Oil Company.

3. Disallowance of a portion of deduction claimed for traveling expenses.

4. Disallowance of one-half of automobile expense claimed.

5. Disallowance of expense for power consumed in 1926.

All issues raised have been given careful consideration and the decisions reached are set forth as follows:

1. An examination of the copy of contract of sale dated December 3, 1927, indicates that certain leases described and identified therein were sold, assigned, transferred and conveyed [11] to the Honolulu Consolidated Oil Company for a basic consideration of $2,000,000.00 to be paid as follows:

Date	Amount
Upon execution of contract	$350,000.00
March 14, 1928	400,000.00
March 14, 1929	400,000.00
March 14, 1920	400,000.00
March 14, 1921	450,000.00
Total	$2,000,000.00

Further provision is made in the contract for the payment of interest attaching to deferred payments due March 14, 1930 and March 14, 1931.

In section 8 of the contract it is provided that from and after the time when the Honolulu Consolidated Oil Company (the purchaser) shall have been fully reimbursed for all expenditures made in the acquisition, development and operation of the properties made the subject of this agreement, the above-named purchaser shall pay to the taxpayer, on the twenty-fifth day of each month 33 1/3% of the net profit resulting from production and operation of said properties during the preceding calendar month.

The consideration of $2,000,000.00 is definite as to amount and periods of payment and it was the entire known consideration when the contract was

executed. The possibility of the taxpayer sharing in the net profits from the operation of the properties conveyed was contingent upon profits being earned great enough to extinguish the full costs of acquisition and development. A careful examination of the contract fails to disclose any reference to the contemplated payment of royalties in any manner, but instead discloses that full title and control passed to the purchaser for a fixed consideration.

In the computation of profit resulting from the sale of these leaseholds the recovery of the entire cost thereof has been allowed during the year of sale, 1927.

In this connection attention is invited to Exhibit A of the report of the agent in charge.

It is held that the payments made during 1927 and 1928, in accordance with the terms of the contract, represent a part of the consideration for the conveyance of the properties transferred [12] and not bonuses or advanced royalty payments subject to depletion as contemplated in article 216, Regulations 69 and article 236, Regulations 74.

2. With reference to the second issue the information at hand discloses that subsequent to October 3, 1927, the taxpayer purchased material and supplies for the account of Honolulu Consolidated Oil Company in the amount of $5,178.65 and charged this amount to the cost of property sold. When payment for these purchases was received surplus account was credited.

In view of the fact that purchaser was obligated by contract to reimburse the taxpayer for all material and supplies purchased after the effective date of the contract, October 3, 1927, it is held that these purchases do not represent a part of the cost of goods sold.

Upon receipt of payment the material and supply account should have been credited. The action of the examining officer in adjusting the net loss for 1927 in this manner is approved. Articles 22, 23 and 101, Regulations 69.

3. The information submitted indicates that traveling expenses claimed were overstated for 1927 and were not substantiated by the books and records submitted for examination. This deduction has been adjusted under the provisions of articles 22, 23 and 101, Regulations 69.

4. Automobile expense claimed for the year 1928 has been allowed in part as shown in the following statement. Items included in this deduction not substantiated by the books and records as the corporation's business expenses have been eliminated. Articles 321, 322 and 121, Regulations 74.

5. The deduction claimed in 1928 for power consumed in 1926 is not allowable. The expenses of one year cannot be used to reduce or offset the income of another. In this connection attention is invited to article 342, Regulations 74. An examination of the facts with respect to this deduction discloses that the taxpayer received full credit for deposits made for electric current in 1926 and that the full amount of payments made therefor repre-

sented expenditures affecting the net income for 1926. Articles 101 and 112, Regulations 69. [13]

A copy of this letter has been furnished your authorized representative, Mr. W. L. E. O'Bryan, c/o Mattison, Davey and Winters, 918 Chrysler Building, 405 Lexington Avenue, New York, New York.

1927.

NET INCOME.

Net income reported		($948.27)
Add:		
1. Additional profit on sale of leaseholds and equipment		28,285.44
		$27,337.17
Deduct:		
2. Additional depreciation	$ 100.00	
3. Additional current expenses	31,843.45	
4. Commissions	15,000.00	46,943.45
Net loss as adjusted		$19,606.28

EXPLANATION OF CHANGES

1. Profit on the sale of leaseholds has been computed under the provisions of articles 1561 and 1571, Regulations 69.

The computation in detail is shown in exhibit A of the revenue agent's report, a copy of which has been furnished you.

Cash received on sales contract in 1927	$350,000.00
Corrected cost of assets sold	238,269.98
Corrected profit realized in 1927	$111,730.02
Profit reported on the return	83,444.58
Additional profit	$28,285.44

2. Depreciation on two frame houses has been computed and allowed as follows:

Description	Cost	Rate Allowed	Depreciation
Frame house, lot No. 78-79	$1,500.00	4%	$60.00
Frame house, lot No. 80	1,000.00	4%	40.00
Total depreciation			$100.00
Brought forward			$100.00
Amount claimed			None
Additional depreciation allowed			$100.00

[14]

The above computation is made under the provisions of article 161, Regulations 69.

3. Rentals, interest and attorney's fees paid or accrued in 1927 are held to constitute deductible expenses for that year and have been eliminated from the cost of properties sold as referred to under explanation No. 1. Article 101, Regulations 69.

The items included in this amount are as follows:

Rentals	$16,160.00
Interest paid	3,754.94
Attorney's fees	10,350.00
Traveling expenses	1,578.51
Total	$31,843.45

Exhibit A attached to the internal revenue agent's report has been corrected with respect to the deduction claimed for traveling expenses which have been allowed to the extent of $1,578.51. The balance of the deduction claimed, $13,100.00 has not been substantiated by your books and records and has therefore been disallowed.

4. Additional commissions in connection with the sale of leaseholds in 1927, paid in 1928 are held to be allowable deductions for the former year. Article 112, Regulations 69.

COMPUTATION OF TAX.

Net loss as adjusted	$19,606.28
Tax assessable	None
Tax assessed	None
Deficiency or overassessment	None

1928.

NET INCOME.

Income reported		$200,821.52
		[15]
Brought forward		$200,821.52
Add:		
1. Previous years' expenses	$ 40,700.00	
2. Depletion disallowed	110,000.00	
3. Traveling expense disallowed	4,564.51	
4. Personal expenses and salary disallowed	2,992.54	158,257.05
Total		$359,078.57
Deduct:		
5. Additional depreciation	$ 100.00	
6. Adjusted net loss for 1927	19,606.28	19,706.28
Net income as adjusted		$339,372.29

EXPLANATION OF CHANGES.

1. Expenses applicable to prior years have been restored to taxable income.

a. Commissions allowed as deductions for 1927	$40,000.00
b. Deposit made in 1925 applied to payment of electric current consumed in that year	700.00
Total	$40,700.00

Commissions disallowed as a deduction for 1928 have been allowed under deductions numbers 3 and 4 for the year 1927. Article 342, Regulations 74.

Advance deposit made in 1925 by McKeon Drilling Company	$1,400.00
During the period from September 15, 1925 to December 9, 1925, the bills for current consumed amounted to	2,080.14
Balance paid by McKeon Drilling Company, January 19, 1926	$ 680.14

[16]

Since the taxpayer was billed for one-half of the current consumed and as these bills were paid in January 1926, it follows that this expense cannot attach to the production of income for 1928.

Amount deducted on return	$700.00
Amount disallowed	$700.00

2. Since the leaseholds formerly owned were sold, conveyed and transferred in 1927 without the retention of royalty rights, the provisions of article 221, Regulations 74 are not applicable and the deduction for depletion has been disallowed.

3. The deduction for traveling expenses, $4,564.51 has been disallowed. The books and records submitted for examination fail to substantiate

this amount as business expenses applicable to the production of the corporation's income for 1928. Articles 121 and 342, Regulations 74.

4. Personal expenses disallowed are computed as follows:

Automobile expense taken	$2,574.52
Insurance	1,561.70
Garage rent	180.00
Depreciation on Lincoln car	1,022.04
Depreciation on other cars	786.85
Total automobile expense claimed	$6,125.11
Excessive salary deduction for Mr. L. D. Barnes, Jr.,	793.96
Total deduction claimed	$6,919.07
Amount allowed	3,926.53
Personal expenses and salary disallowed	$2,992.54

The items constituting the amount disallowed are as follows:

Date	Description of Bill	Amount
May 1928	S. S. Nerney, Los Angeles (personal)	$ 6.50
August 1928	L. S. Barnes, Jr.	50.00
September 1928	Maddox, Inc., Lincoln car	124.50
September 1928	Beverly Hills Garage	24.87
November 1928	Shelton Garage, Beverly Hills, Gas and oil	49.38
November 1928	Beverly Hills Garage, Gas and oil	46.55
December 1928	Beverly Hills Garage, Gas and oil	13.08

[17]

Brought forward			$314.88
December 1928	Shelton Garage, Gas and oil		56.10
May 4, 1928	Southern California Auto Club, Lincoln insurance		163.05
August 11, 1928	Southern California Auto Club, Buick Sedan insurance		136.16
October 1928	New top for Pierce Arrow (from Saggor Mfg. Co.)		675.00
			$1,345.19
Depreciation claimed on automobiles		$1,808.89	
Cost of Pierce Arrow	$3,147.00		
New top in 1928	675.00		
Total cost	$3,822.00		
Depreciation at 25% allowed		955.50	
Depreciation on other cars disallowed			853.39
Portion of salary disallowed			793.96
Personal expenses and salary disallowed			$2,992.54

The expense items listed above appear to cover personal expenses of Mr. L. S. Barnes and family including depreciation on Lincoln and Buick cars kept at the home of Mr. Barnes for the use of his family. The cost of a new top for the Pierce Arrow car in 1928 has been treated as a capital expenditure and depreciation allowed thereon at the rate of 25%.

The salary adjustment is fully explained in schedule 3-A of the revenue agent's report.

This adjustment is made under the provisions of articles 121 and 323, Regulations 74.

5. Depreciation on frame buildings has been allowed on the same basis as for the year 1927. See

explanation of adjustment No. 2 of adjustments to net income for 1927 and article 201, Regulations 74.

6. The adjusted net loss for 1927 has been allowed as a deduction as provided in article 652, Regulations 74. [18]

COMPUTATION OF TAX

Net income as adjusted	$339,372.29
Income tax at 12%	$40,724.67
Tax previously assessed	24,098.58
Deficiency in tax	$16,626.09

[Endorsed]: Filed March 27, 1931. [19]

[Title of Court and Cause—Docket No. 54773.]

ANSWER

The Commissioner of Internal Revenue, by his attorney, C. M. Charest, General Counsel, Bureau of Internal Revenue, for answer to the petition of the above-named petitioner, admits and denies as follows:

1. Admits the allegations of paragraph 1.

2. Admits the allegations of paragraph 2.

3. Admits that the taxes in controversy are income taxes for the calendar year 1928 but denies that the amount in controversy is $16,626.09 as alleged in paragraph 3.

4. Denies that the Commissioner erred as alleged in paragraph 4 and its subdivisions.

5. Denies each and every allegation of paragraph 5 and its subdivisions which is inconsistent with or

contrary to the determination of the Commissioner as set forth in the deficiency notice.

6. Denies, generally and specifically, each and every allegation of the petition not hereinbefore admitted, qualified or denied.

WHEREFORE, it is prayed that the appeal be denied.

C. M. CHAREST,
General Counsel,
Bureau of Internal Revenue.

Of Counsel:
ELDEN McFARLAND,
ARTHUR CLARK,
Special Attorneys,
Bureau of Internal Revenue.

[Endorsed]: Filed Apr. 28, 1931. [20]

[Title of Court and Cause—Docket No. 60157.]

PETITION

The above named corporation hereby appeals from the determination of the Commissioner of Internal Revenue set forth in his letter (IT:AR:E-6 EIM-60D), dated September 8, 1931, and as the basis of its appeal sets forth the following:

1. The petitioner is the Elbe Oil Land Development Company, a California corporation, whose business address is 714 West Tenth Street, Los Angeles, California.

2. The deficiency letter, a copy of which is attached, was mailed to the petitioner on September 8, 1931 and states an alleged liability of $12,149.50.

3. The taxes in controversy are income taxes for the calendar year 1929, and are in the amount of $12,149.50.

4. The determination of tax set forth in said notice of deficiency is based upon the following errors:

(a) The respondent erred in holding the October 3, 1927 agreement with the Honolulu Consolidated Oil Company to have been a sale and not a sublease and in failing to allow the petitioner depletion on bonuses and royalties received under the terms of the agreement.

(b) The respondent erred in failing to allow as deductions, business expense in the amount of $550.00.

(c) The respondent has erred in calculations of income and the tax based thereon. [21]

5. The facts upon which the petitioner relies as the basis of this proceeding are as follows:

(a) The petitioner, by reason of an agreement with the Honolulu Consolidated Oil Company, dated October 3, 1927, was the owner of a sublease on certain properties and by reason of this sublease received certain amounts in 1929 as bonuses or royalties. These amounts are subject to depletion allowances as provided in Section 114 (a) (3) and Section 23 (a) of the Revenue Act of 1928.

(b) The petitioner, during the year 1929 paid to the Jonathan Club the amount of $550.00, which amount was paid for and as a business expense.

(c) The petitioner calls attention to the mathematical error in the respondent's income figures of $70.00. The respondent's income figures showing $304,382.16 whereas the correct figures, using respondent's adjustments to which the petitioner is taking exception, is $304,312.16.

WHEREFORE, the petitioner prays that this Board may hear this proceeding and rule:

(a) That the petitioner is entitled to depletion on amounts received during the year 1929 by reason of the agreement with the Honolulu Consolidated Oil Company, dated October 3, 1927.

(b) That the amount of $550.00 paid to the Jonathan Club is deductible as a business expense.

(c) That there is a mathematical error in the respondent's computation of the income shown in his letter of September 8, 1931.

W. L. E. O'BRYAN,
Counsel for Taxpayer,
707 South Hill Street,
Los Angeles, California. [22]

State of California,
County of Los Angeles—ss:

L. S. Barnes, being duly sworn, deposes and says: that he is the Secretary and Treasurer of the Elbe Oil Land Development Company, the petitioner named in the foregoing petition, and as such is duly authorized to and does verify the foregoing petition; that he is familiar with the statements contained therein and that the facts stated are true and correct to the best of his knowledge and belief.

L. S. BARNES.

Subscribed and sworn to before me this 2nd day of October, 1931.

[Seal] MAI FIELD DOUGLAS,
Notary Public. My Commission Expires December 14, 1933. [23]

TREASURY DEPARTMENT
Washington

Office of
Commissioner of Internal Revenue
Address reply to
Commissioner of Internal Revenue
and refer to

Sept. 8, 1931

Elbe Oil Land Development Company,
702 Petroleum Securities Building,
Los Angeles, California.

Sirs:

You are advised that the determination of your tax liability for the year 1929 discloses a deficiency of $12,149.50, as shown in the statement attached.

In accordance with section 272 of the Revenue Act of 1928, notice is hereby given of the deficiency mentioned. Within sixty days (not counting Sunday as the sixtieth day) from the date of the mailing of this letter, you may petition he United States Board of Tax Appeals for a redetermination of your tax liability.

HOWEVER, IF YOU DO NOT DESIRE TO PETITION, you are requested to execute the enclosed agreement form and forward it to the Commissioner of Internal Revenue, Washington, D. C., for the attention of IT:C:P-7. The signing of this agreement will expedite the closing of your return by permitting an early assessment of any deficiency and preventing the accumulation of interest charges, since the interest period terminates thirty days after filing the enclosed agreement, or on the date assessment is made, whichever is earlier; WHEREAS IF NO AGREEMENT IS FILED, interest will accumulate to the date of assessment of the deficiency.

Respectfully,
DAVID BURNET,
Commissioner.
By (Signed) J. C. WILMER
Deputy Commissioner.

Enclosures:
Statement
Form 882
Form 870 [24]

STATEMENT

IT:AR:E-6
EIM-60D

In re: Elbe Oil Land Development Company,
702 Petroleum Securities Building,
Los Angeles, California.

Tax Liability.

Year—1929.
Tax Liability—$33,474.34.
Previously Assessed—$21,324.84.
Deficiency—$12,149.50.

The report of the internal revenue agent at Los Angeles, California, covering an investigation of your books of account and record for the year 1929, has been reviewed and approved by this office.

A computation of your taxable net income is as follows:

1929.		
Net income reported on return		$193,862.16
Add: 1. Depletion	$110,000.00	
2. Initiation fee	550.00	110,550.00
		$304,382.16
Deduct: 3. Depreciation		100.00
Net income adjusted		$304,382.16

EXPLANATION OF CHANGES

1. Depletion of 27½% on $400,000.00 claimed on your return has been disallowed since the leaseholds formerly owned were sold in the year 1927 without the retention of royalty rights, therefore,

the provisions of article 221, Regulations 74 are not applicable.

It appears that during 1927 certain leases owned by the corporation were sold to the Honolulu Consolidated Oil Company for a consideration of $2,000,000.00 to be paid as follows:

Date	Amount
Upon execution of contract	$350,000.00
March 14, 1928	400,000.00
March 14, 1929	400,000.00
March 14, 1930	400,000.00
March 14, 1931	450,000.00
Total	$2,000,000.00

[25]

It is held that the payment received during the year 1929, in accordance with the terms of the contract of sale represent a part of the consideration for the conveyance of the properties transferred, and not advanced royalties subject to depletion allowance as contemplated in article 236, Regulations 74.

In General Counsel Memorandum 1023, Cumulative Bulletin VI-1, page 19, it is held that income arising from the sale of oil and gas property or any interest therein may not be taken into consideration in computing the allowance for depletion. To the same effect see case of Darly-Lynde Co. v. Acel C. Alexander, Collector of Internal Revenue, Ct. D. 245, Cumulative Bulletin IX-2, page 176.

2. This item represents certain fee paid to the Jonathan Club which is disallowed as an ordinary and necessary expense.

3. Additional depreciation has been allowed on fixed assets computed as follows:

Asset	Cost	Rate	Allowance
Dwelling	$2,500.00	4%	$100.00
Depreciation claimed			none
Depreciation allowed			$100.00

COMPUTATION OF TAX.

Net income adjusted	$304,382.16
Income tax at 11%	33,474.34
Tax previously assessed, Account #402627	21,324.84
Deficiency	$ 12,149.50

Since the prior year 1928 is now before the United States Board of Tax Appeals, and the same issue is involved for the year 1929 a final letter of determination is being issued in accordance with section 272 of the Revenue Act of 1928.

[Endorsed]: Filed Oct. 9, 1931. [26]

[Title of Court and Cause—Docket No. 60157.]

ANSWER

The Commissioner of Internal Revenue, by his attorney, C. M. Charest, General Counsel, Bureau of Internal Revenue, for answer to the petition of the above-named petitioner, admits and denies as follows:

1. Admits the allegations of paragraph 1.

2. Admits the allegations of paragraph 2.

3. Admits that the taxes in controversy are income taxes for the calendar year 1929, but denies that the amount in controversy is $12,149.50 as alleged in paragraph 3.

4. Denies that the Commissioner erred as alleged in paragraph 4 and its subdivisions.

5. Denies each and every allegation of paragraph 5 and its subdivisions which is inconsistent with or contrary to the determination of the Commissioner as set forth in the deficiency notice.

6. Denies, generally and specifically, each and every allegation of the petition not hereinbefore admitted, qualified or denied.

WHEREFORE, it is prayed that the Board redetermine the amount of the deficiency involved in this proceeding to be equal to the amount determined by the Commissioner plus any additional amount which may arise from the correction of any error or errors that may have been committed by the Commissioner. Claim is hereby asserted for the increased deficiency, if any, resulting from such redetermination.

(Signed) C. M. CHAREST,
General Counsel,
Bureau of Internal Revenue.

Of Counsel:
ELDEN McFARLAND,
ARTHUR CLARK,
Special Attorneys,
Bureau of Internal Revenue.

[Endorsed]: Filed Nov. 27, 1931. [27]

[Title of Court and Cause—Docket Nos. 54773, 60157.]

STIPULATION OF FACTS.

It is stipulated by and between the above-named parties by their respective counsel, that the following facts may be taken as true subject to the right of either party to submit further and additional facts not in conflict therewith.

1. Petitioner is a corporation organized February 4, 1925, under the laws of the State of California. It acquired certain properties consisting of oil and gas prospecting permits, drilling agreements, leases and drilling and producing equipment. It carried on a substantial amount of development work resulting in the discovery of oil and on October 3, 1927, oil was being produced in commercial quantities.

As of October 3, 1927, petitioner entered into an agreement with Honolulu Consolidated Oil Company, a California corporation. A copy of the agreement is attached hereto and marked Exhibit A. Pursuant to the terms of the agreement, petitioner transferred its assets to Honolulu Consolidated Oil Company, and it received the following sums of money at the times stated, to-wit:— [28]

Upon execution of contract, (November 1927)	$ 350,000.00
March 14, 1928,	400,000.00
March 14, 1929,	400,000.00
March 14, 1930,	400,000.00
March 14, 1931,	450,000.00
Total	$2,000,000.00

That of the $2,000,000, to be received by the petitioner in cash and notes, $1,963,672.95 was consideration for the oil and gas rights in the leases and the remainder was consideration for equipment and other property.

Up to the present time no repayments have become due or have been paid under the provisions of paragraph 8 of said agreement providing for the payment to petitioner of 33 1/3% of the net profits resulting from the operation of the properties under the conditions set forth.

The total cost of all assets transferred pursuant to said agreement was less than the amount of $350,000.00 received in 1927. In its income tax return for that year the petitioner reported a taxable gain of $83,444.58 by applying the entire basis against $350,000.00. It reported losses from operations sufficient to indicate a net loss of $948.27. Upon investigation, the Revenue Agent increased the gain on sale of $28,285.44 but increased deductions to the extent that a net loss of $18,027.77 was indicated. This net loss was increased by the income tax unit to $19,606.28 and was applied in the deficiency notice, as a deduction for 1928.

In filing its income tax return for 1928, the petitioner submitted a statement indicating that by the agreement dated October 3, 1927, it in effect subleased its properties and that the payments received by it were bonuses or advance royalties. The amount of $400,000.00 was returned as gross income as "bonus on sublease." A deduction of $110,000.00

was claimed for depletion representing 27½ per cent of $400,000.00. In its income [29] tax return for the year 1929, petitioner returned the amount of $400,000.00 as advance royalties and a similar deduction of $110,000.00 was claimed for depletion.

The Bureau disallowed the depletion deductions for both 1928 and 1929.

2. Petitioner waives the assignment of error set forth in Subdivision (b), Paragraph 4 of its petition in docket No. 54773.

3. The parties agree that the deductions claimed in Subdivision (c) of Paragraph 4 of the petition in Docket No. 54773, should be allowed to the extent of $11,775.03 for the year 1927, and $4,564.51 for the year 1928.

4. The parties agree that the deductions claimed in Subdivision (d) of Paragraph 4 of the petition in Docket No. 54773, should be allowed to the extent of $344.05.

5. The parties agree that the deduction claimed in Subdivision (e) of Paragraph 4 of the petition in Docket No. 54773, should be allowed to the extent of $1,022.04.

6. The parties agree that the deductions claimed in Subdivision (f) of Paragraph 4 of the petition in Docket No. 54773, should be allowed to the extent of $1,452.37.

7. Petitioner waives the issue of the Statute of Limitations set forth in Subdivision (g) of Paragraph 4 of the petition in Docket No. 54773.

8. Petitioner waives the issues set forth in Subdivisions (b) and (c) of Paragraph 4 of the petition in Docket No. 60157.

It is further stipulated that this case may be submitted upon [30] the pleadings and upon this stipulation of facts without the necessity of further appearance at the time set for hearing.

W. L. E. O'BRYAN
Attorney for Petitioner.

E. BARRETT PRETTYMAN
General Counsel, Bureau of Internal Revenue,
Attorney for Respondent. [31]

THIS AGREEMENT, made as of the 3rd day of October, 1927, by and between ELBE OIL LAND DEVELOPMENT COMPANY, a corporation organized and existing under and by virtue of the laws of the State of California, first party (hereinafter referred to as "ELBE"), and HONOLULU CONSOLIDATED OIL COMPANY, a like corporation, second party (hereinafter referred to as "HONOLULU"),

WITNESSETH:

WHEREAS, ELBE is the assignee and owner and holder of those certain United States Oil and Gas Prospecting Permits (hereinafter referred to as "Permits"), covering all of Section Eighteen (18), the north half and the southeast quarter of Section Twenty (20), and all of Section Twenty-eight (28), in Township Twenty-eight (28) South,

Range Twenty-nine (29) East, Mount Diablo Base and Meridian, Kern County, California; and has made and entered into drilling agreements, dated April 7th, 1927, with B. M. Tibbet, Harriet E. Douglas, Harry Sheehan and Olive M. Davis (formerly Olive M. Lowry), hereinafter referred to as "Permittees of Section Eighteen (18), in respect to the drilling of oil and/or gas wells on said Section Eighteen (18); and has also made and entered into a drilling agreement with A. J. Matthews, dated October 15th, 1927, in respect to the drilling of oil and/or gas wells on the north half and the southeast quarter of said Section Twenty (20), and all of said Section Twenty-eight (28); and [32]

WHEREAS, ELBE is the lessee under oil and gas leases covering the southwest quarter of Section Twenty (20); all of Section Twenty-nine (29); Lots One (1), Two (2) and Three (3) and the east half of the northwest quarter and the northeast quarter of the southwest quarter of Section Thirty (30), and the northeast quarter of Section Thirty-one (31), Township Twenty-eight (28) South, Range Twenty-nine (29) East, Mount Diablo Base and Meridian, Kern County, California; and

WHEREAS, ELBE has heretofore agreed to sell and HONOLULU to purchase all of ELBE'S right, title and interest in and to said permits and drilling agreements and leases, upon the terms and conditions hereinafter set forth:

NOW, THEREFORE, in consideration of the mutual promises and covenants of the parties hereto, said parties do hereby agree as follows:

1. ELBE hereby grants, bargains, sells, assigns, transfers and conveys unto HONOLULU all of ELBE'S right, title and interest in and to the following described property, to-wit:

PARCEL ONE.

(a) Five United States Oil and Gas Prospecting Permits, issued pursuant to the Act of Congress approved February 25th, 1920, and entitled "An Act to Promote the Mining of Coal, Phosphate, Oil, Oil Shale, Gas and Sodium on the Public Domain," which said permits are particularly described as follows: [33]

(1) Sacramento No. 019845 (formerly Visalia No. 010682), issued to B. M. Tibbet and covering the northeast quarter of Section Eighteen (18), Township Twenty-eight (28) South, Range Twenty-nine (29) East, Mount Diablo Base and Meridian;

(2) Sacramento No. 019846 (formerly Visalia No. 010683), issued to Harriet E. Douglas and covering the northwest quarter of Section Eighteen (18), Township Twenty-eight (28) South Range Twenty-nine (29) East, Mount Diablo Base and Meridian;

(3) Sacramento No. 019847 (formerly Visalia No. 010684), issued to Harry Sheehan and covering the southwest quarter of Section Eighteen (18), Township Twenty-eight (28) South, Range Twenty-nine (29) East, Mount Diablo Base and Meridian;

(4) Sacramento No. 019848 (formerly Visalia No. 010685), issued to Olive M. Lowry and covering the southeast quarter of Section Eighteen (18), Township Twenty-eight (28) South, Range Twenty-nine (29) East, Mount Diablo Base and Meridian;

(5) Sacramento No. 019840 (formerly Visalia No. 010673), issued to A. J. Matthews and covering the north half and the southeast quarter of Section Twenty (20) and all of Section Twenty-eight (28), Township Twenty-eight (28) South, Range Twenty-nine (29) East, Mount Diablo Base and Meridian;

together with all right, title, interest, claim and demand of Elbe in and to the premises embraced within said permits, and in and to all wells drilled and completed and/or being drilled upon the premises covered by said permits.

(b) Five drilling agreements more particularly described as follows:

(1) Agreement dated April 7th, 1927, between L. S. Barnes and B. M. Tibbet in respect to drilling the lands covered by United States Gas and Oil Prospecting Permit, Sacramento No. 019845;

(2) Agreement dated April 7th, 1927, between L. S. Barnes and Harriet N. Douglas in respect to [34] drilling the lands covered by United States Gas and Oil Prospecting Permit, Sacramento No. 019846;

(3) Agreement dated April 7th, 1927, between L. S. Barnes and Harry Sheehan in respect to drilling the lands covered by United States Gas and Oil Prospecting Permit, Sacramento No. 019847;

(4) Agreement dated April 7th, 1927, between L. S. Barnes and Olive M. Lowry in respect to drilling the lands covered by United States Gas and Oil Prospecting Permit, Sacramento No. 019848;

(5) Agreement dated October 15th, 1927, between Elbe Oil Land Development Company and A. J. Matthews in respect to drilling the lands covered by United States Gas and Oil Prospecting Permit, Sacramento No. 019840.

and any and all agreements amendatory thereof or supplementary thereto.

PARCEL TWO.

Four leases more particularly described as follows:

(1) Oil and gas lease from W. D. Freeman and Clara B. Freeman, his wife, as lessors, to Elbe Oil Land Development Company, as lessee, dated June 18th, 1926, and covering the southwest quarter of said Section Twenty (20), Township Twenty-eight (28) South, Range Twenty-nine (29) East, Mount Diablo Base and Meridian.

(2) Oil and gas lease from Lucy Eleanor Jewett and S. Wright Jewett, her husband, as

lessors, to Elbe Oil Land Development Company, as lessee, dated April 9th, 1927, and covering the east half of Section Twenty-nine (29), Township Twenty-eight (28) South, Range Twenty-nine (29) East, Mount Diablo Base and Meridian;

(3) Oil and gas lease from Thomas N. Harbert and Phoebe A. Harbert, his wife, as lessors, to Elbe Oil Land Development Company, as lessee, dated February 10, 1927, and covering Lots One (1), Two (2) and Three (3) and the east half of the northwest quarter and the [35] northeast quarter of the southwest quarter of said Section Thirty (30), Township Twenty-eight (28) South, Range Twenty-nine (29) East, Mount Diablo Base and Meridian;

(4) Oil and Gas lease from Lucy Eleanor Jewett and S. Wright Jewett, her husband, as lessors, to Elbe Oil Land Development Company, as lessee, dated October 25th, 1926, and covering the west half of said Section Twenty-nine (29) and the northeast quarter of said Section Thirty-one (31), Township Twenty-eight (28) South, Range Twenty-nine (29) East, Mount Diablo Base and Meridian;

together with all right, title, interest, claim and demand of ELBE in and to the premises embraced within said leases, and in and to all wells drilled or completed and/or being drilled upon the premises covered by said leases.

PARCEL THREE.

All derricks, rigs, tools, appliances and all machinery, pipe and pipe lines and oil and/or water storage tanks and all other personal property now located upon any of the lands described in Parcels One and Two, except the tools and machinery now used in drilling Elbe Well No. 6, located on the southwest quarter of the said Section Twenty (20); provided, however, that HONOLULU, without charge, shall have the exclusive right to use said tools and machinery now used in drilling said Elbe Well No. 6 until said well is completed, at which time said tools and machinery shall be returned to ELBE, in the condition they are in at that time. [36]

PARCEL FOUR.

An agreement dated April 22nd, 1927, between Lucy Eleanor Jewett and her husband, S. Wright Jewett, as parties of the first part, and Elbe Oil Land Development Company, as party of the second part, in reference to the exclusive right, for a period of twenty years from said date, to use all water in that certain well situated on the northwest corner of Section Thirty-one (31), Township Twenty-eight (28) South, Range Twenty-nine (29) East, Mount Diablo Base and Meridian, together with all pumps, tools, machinery and appliances now used thereon or in connection therewith.

2. ELBE agrees to defend and hold HONOLULU harmless from any loss or liability whatsoever on account of any lien or encumbrance for work and/or labor done and/or materials furnished, at the request of ELBE, and used on the properties described in Parcels One, Two and Four above.

ELBE agrees to join in and make all necessary applications to the Department of Interior of the United States, for the purpose of securing the consent of the said Secretary of the Interior to the assignment of said permits to HONOLULU, and HONOLULU shall have the right, and is hereby authorized, to make all necessary and proper applications, in the name and in behalf of ELBE, for the purpose of securing any extensions or modifications of said permits, or any lease or leases granted pursuant thereto. [37]

ELBE warrants title to the personal property described in Parcel Three hereof, and that the same is free and clear of all claims, demands, liens and encumbrances; and ELBE agrees to defend and hold HONOLULU harmless from any and all claims, demands, losses and/or liabilities occasioned by any claim, demand, lien and/or encumbrance thereon.

3. Possession of the properties above described shall immediately vest in HONOLULU, and HONOLULU shall have full charge and control of all drilling and other work to be performed in connection with said permits and drilling agreements and leases and the lands covered thereby, and shall

have the sole ownership of and the right to sell or otherwise dispose of, all oil and/or gas and derivative products produced in, on or upon said properties. It is the intention of the parties to this agreement that the full and complete ownership, control and operation of said properties shall vest, upon execution hereof, in HONOLULU (Subject to the provisions of Paragraph 9), and ELBE shall have no interest in or to any of said properties whatsoever.

4. HONOLULU hereby assumes and agrees to perform each and every covenant on ELBE'S part to be performed under and by virtue of said drilling agreements, and to drill all wells and do and perform all work and labor required by the United States, in order to protect said permits, at the times and in the manner required by any law of the United States or rule or regulation of the proper governmental department thereof, or any amendment thereto or supplement or modification [38] thereof, provided, however, that in the event the Secretary of the Interior shall require all of said permits to be consolidated, along with any other permit or permits held by HONOLULU, in one permit, in the name of HONOLULU, as assignee, HONOLULU shall not be obligated to drill any more wells or do or perform any more work or labor than necessary to prevent default in said drilling agreements, and than may be required by any law of the United States or rule or regulation

of the proper governmental department thereof, in order to protect such consolidated permit.

HONOLULU shall have the right, and is hereby authorized, to negotiate with, and obtain from, the government of the United States and/or the original permittees, any modification and/or extension of the said permits and/or the said drilling agreements (hereinabove described in Parcel One). HONOLULU shall pay to ELBE any and all sums actually expended by ELBE in the operation and development of any or all of the properties, subject to this agreement, after October 3, 1927, and such further sum or sums as ELBE shall expend at the request of HONOLULU for the purpose of securing any modification and/or extension and/or consolidation of said permits and/or the said drilling agreements (hereinabove described in Parcel One).

5. HONOLULU hereby assumes and agrees to perform each and every covenant on ELBE'S part to be performed under and by virtue of said leases, and to drill all wells and do [39] and perform all work and labor required by the terms of said leases, in order to protect the same.

HONOLULU shall have the right, and is hereby authorized, to negotiate with, and obtain from the original lessors any modification and/or extension of the said leases (hereinabove described in Parcel Two), consulting only its own interest in respect thereto, and shall be entitled to all benefits derived therefrom.

5. HONOLULU shall pay to the government of the United States the royalty or royalties provided

by said permits, or any lease or leases issued by reason thereof, and as may be required pursuant to any law of the United States or rule or regulation of the proper governmental department thereof, and shall further pay to the original permittees, or their assignees of record, the royalty reserved to said permittees, or assignees of record, as their respective interests may appear, under and by virtue of the said drilling agreements, and shall further pay to the lessors of the lands covered by said leases the royalty reserved to the said lessors, as their respective interests may appear under and by virtue of the said leases.

7. HONOLULU shall pay to ELBE, upon the execution of this agreement and the approval by HONOLULU of ELBE'S title to all of said properties, the subject of this agreement, the sum of Three Hundred Fifty Thousand ($350,000.00) Dollars. ELBE hereby acknowledges that HONOLULU has heretofore advanced [40] to ELBE the sum of Fifty Thousand ($50,000.) Dollars, which said sum shall be credited as part payment of the said sum of Three Hundred Fifty Thousand ($350,000.) Dollars.

Thereafter, HONOLULU, if it shall not elect to abandon the purchase of said properties as provided by Paragraph 9 hereof, shall further pay to ELBE the sum of Four Hundred Thousand ($400,000.) Dollars on the 14th day of March, 1928, a like sum on the 14th day of March, 1929, a like sum on the 14th day of March, 1930, together with interest on

said last mentioned sum from March 14, 1929, until paid, at the rate of two and one-half (2½%) percent per annum, payable annually, and the further sum of Four Hundred and Fifty Thousand ($450,000.) Dollars on the 14th day of March, 1931, together with interest on said last mentioned sum from the 14th day of March, 1929, until paid, at the rate of two and one-half percent (2½%) per annum, payable annually.

8. From and after the time when HONOLULU shall have been fully reimbursed, in the manner and to the extent hereinafter provided, for all expenditures made in the acquisition, development and operation of the properties which are the subject of this agreement, HONOLULU shall pay to ELBE, on the twenty-fifth day of each and every month, thirty-three and one-third (33-1/3%) percent of the net profits (as such term is hereinafter defined) resulting from the production and operation of said properties during the preceding calendar month. [41]

The reimbursement of HONOLULU for all expenditures made and/or incurred in the acquisition, development and operation of said properties shall be computed at the time of the actual sale in the field of said oil and/or gas or derivative products, by valuing all of said oil and/or gas or derivative products produced in, on or upon and saved from the lands described in and covered by said United States Government Prospecting Permits, referred to in Parcel One above (exclusive of all royalties

paid to the United States and all royalties paid under and by virtue of said drilling agreements referred to in Parcel One (b) above), at seven and one-half (7½%) percent less than the current market price at the well for such oil and/or gas or derivative products, and by valuing all oil and/or gas or derivative products produced in, on or upon and saved from the lands described in and covered by said leases, referred to in Parcel Two above (exclusive of all royalties paid to the original lessors under and by virtue of said leases) at five (5%) percent less than the current market price at the well for such oil and/or gas or derivative products, and deducting therefrom the following items:

(a) All payments made by HONOLULU to ELBE in connection with the acquisition of said properties, including interest, as provided by Paragraph 7 hereof; and

(b) All expenditures made or incurred by HONOLULU in securing the consent of the Secretary of the [42] Interior to the assignment of said permits to HONOLULU, together with all costs of making or securing any lease or leases pursuant to said permits, or any modification or consolidation thereof, and/or in complying with any laws, rules or regulations of the United States, or the proper governmental department thereof, and/or in securing any assignments, extensions or modifications of said leases described in Parcel Two, including

any and all sums paid by HONOLULU to ELBE for the operation of the properties, the subject of this agreement, after October 3, 1927, and all sums paid by HONOLULU to ELBE for the purpose of securing any modifications and/or extension and/or consolidation of the said permits and/or the said drilling agreements;

(c) All expenditures made or incurred by HONOLULU in the acquisition and installation and maintenance of all machinery, tools and facilities necessary for the development and/or the operation of said properties, and for the production of oil and/or gas thereon, and for the manufacture of casinghead gasoline and/or other derivative products, including all expenditures incident to the development and operation of said properties and/or auxiliary to the said production of oil and/or gas or derivative products; and [43]

(d) The part or portion of the general administrative and overhead expense of HONOLULU in connection with the supervision or administration of all properties owned and/or controlled by HONOLULU, including the properties, the subject of this agreement, directly attributable to the acquisition and/or incident to the ownership, development and operation of the properties, the subject of this agreement.

HONOLULU shall be the sole judge of the character and necessity and extent of said expen-

ditures of acquisition, development and operation of said properties, as above defined, and may expend any and all sums which, in its judgment, may be reasonably necessary therefor; and the enumeration of particular items of expenditure hereinabove set forth shall not preclude or prevent HONOLULU from including in such expenditures any and all expenditures actually made or incurred by HONOLULU in the acquisition, development and operation of said properties.

In the event that the parties hereto shall disagree in reference to the propriety of any charge or charges made by HONOLULU in computing its reimbursement as above provided, the propriety of such charge or charges shall be conclusively determined by Mattison and Davey, certified public accountants of San Francisco, California. Upon thirty (30) days notice in writing given to HONOLULU by ELBE, ELBE shall [44] have the right, at the end of any calendar year after the year 1927, to designate a firm of certified public accountants of San Francisco, California, which shall be acceptable to HONOLULU, to determine the propriety of any charge or charges made by HONOLULU in computing its reimbursement as above provided, in lieu of said Mattison and Davey.

The term "market price" as used in this agreement shall mean the market price established by Standard Oil Company of California in the district wherein the said properties are located, for oil and/or gas or derivative products of like kind and

gravity; and in the event Standard Oil Company of California shall not establish any market price for the district wherein said properties are located, then the market price shall be the published field price for oil and/or gas or derivative products of like kind and gravity, in the nearest district.

The term "net profits" as used in this agreement shall be the profits resulting to HONOLULU from the production and operation of said properties, computed in the following manner, to-wit:

The value, at the time of actual sale in the field of all oil and/or gas or derivative products produced in, on or upon, and saved from, the lands described in and covered by said United States Government Prospecting Permits, referred to in Parcel One above, at seven and one-half (7½%) percent less than the current market price at the well for such oil [45] and/or gas or derivative products, and all oil and/or gas or derivative products, produced in, on or upon, and saved from, the lands described in and covered by said leases, referred to in Parcel Two above, at five (5%) percent less than the current market price at the well for such oil and/or gas or derivative products, LESS:

(1) Royalties paid to the Government of the United States by HONOLULU and royalties paid by HONOLULU to the original permittees or their assignees under and by virtue of said drilling agreements in respect to the drilling of the lands covered by said permits referred to in Parcel One hereof; and

(2) Royalties paid to the original lessors under and by virtue of said leases, referred to in Parcel Two hereof; and

(3) Expenses of development and operation of said properties as said terms are defined in sub-paragraphs (b), (c) and (d) of this paragraph 8.

All expenditures made or incurred by HONOLULU, as provided by sub-paragraphs (a), (b), (c) and (d) above, shall bear interest at the rate of two and one-half (2½%) percent per annum until paid, and shall be computed on the basis of average monthly increasing or decreasing balances of total net expenditures, and ELBE hereby agrees to pay such interest out of the first of the net profits payable to ELBE by HONOLULU, as above provided. Interest payable by ELBE to HONOLULU on the net expenditures made during each calendar month, shall be averaged on the 15th day of each calendar month, and shall accrue from and after forty-five (45) days after the fifteenth day of the month, in which such expenditures were made. Interest payable by ELBE to HONOLULU shall not be compounded. [46]

The term "net expenditures" as the same is used in this agreement, shall be the total expenditures for the current calendar month, less the total proceeds, if any (valued in the manner provided by Paragraph 8 hereof), resulting from the actual sale in the field of oil and/or gas or derivative products

produced in, on or upon, and saved from, said properties during said calendar month.

In the event HONOLULU shall, at any time, be permitted to suspend operations and development work upon said properties, or any part thereof, by reason of any provision in said permits or any law of the United States or rule or regulation of the proper governmental department thereof, or by reason of any provision of said drilling agreements, or by reason of any provision of said leases, then, and during such period of suspension, said expenditures, upon the properties on which operation and development shall have been suspended, shall cease to bear interest.

It is the intention of the parties to this agreement that all the reimbursement of HONOLULU shall be made from the oil and/or gas or derivative products produced in, on or upon, and saved from, the properties, the subject of this agreement, and that all interest payable by ELBE to HONOLULU, as above provided, shall be payable out of net profits resulting from the operation of said properties payable to ELBE by HONOLULU and not otherwise, and in the event the net profit resulting from the operation of the said properties payable to ELBE by HONOLULU shall not [47] be sufficient to pay the said interest payable by ELBE to HONOLULU, said interest shall accrue and become payable only at such time as the net profits payable to ELBE by HONOLULU shall be sufficient to pay the same.

9. The properties hereinabove described in Par-

agraph 1 (being Parcels One, Two, Three and Four) shall be reconveyed by HONOLULU to ELBE, and HONOLULU shall make, execute and deliver to ELBE appropriate instruments of reconveyance upon the following conditions, and not otherwise:

(a) In the event that on or before March 14, 1928, HONOLULU shall notify ELBE, in writing, of HONOLULU'S desire to abandon the purchase of said properties, then HONOLULU shall not be obligated to make any further payments to ELBE (other than the payment of Three Hundred and Fifty Thousand ($350,000.) Dollars on the execution of this agreement and approval of title, as provided by Paragraph 7 hereof) and ELBE shall have the right to the immediate possession of all of said properties, except producing wells and wells then in process of drilling, and their respective well sites, which shall include the property within a square having sides, running due north and south, and east and west, tangent to a circle, with the said well at the center, having a radius of four hundred (400) feet, together with all equipment and appurtenances necessary to operate said wells and/or [48] complete the drilling thereof. HONOLULU shall remain in possession of said producing wells and wells then in process of drilling, and their respective well sites, together with all necessary equipment and appurtenances, and

shall have the right, if it so elects, to complete and operate said wells until such time as HONOLULU shall be reimbursed in full for all expenditures made in the acquisition of said properties and in the operation and development thereof, together with interest thereon, including expenditures made from and after said March 14, 1928, in the development and operation of the wells and well sites retained by HONOLULU, in the manner above provided in respect to reimbursement of HONOLULU by paragraph 8 hereof.

HONOLULU shall have all necessary rights of way for ingress and egress, roads, water, water lines, pipe lines, and all other necessary appurtenances in the operation of the properties retained by HONOLULU, and shall have a lease and/or assignment of said producing wells and wells in process of drilling, and their respective well sites, and HONOLULU shall have the exclusive operation and control of said producing wells and wells in process of drilling, until such time as HONOLULU shall be reimbursed in full for all expenditures made by HONOLULU, and interest thereon, [49] in the manner above provided; or

(b) In the event that on or before March 14, 1929, HONOLULU shall notify ELBE, in writing, of HONOLULU'S desire to abandon the purchase of said properties, then HONOLULU shall not be obligated to make any fur-

ther payments to ELBE (other than the payment of Three Hundred and Fifty Thousand ($350,000.) Dollars on the execution of this agreement and approval of title, and the payment of Four Hundred Thousand ($400,000.) Dollars on the 14th day of March, 1928, as provided by Paragraph 7 hereof), and ELBE shall have the right to the immediate possession of all of said properties, except producing wells and wells then in process of drilling, and their respective well sites, which shall include the property within a square having sides, running due north and south, and east and west, tangent to a circle, with the said well at the center, having a radius of four hundred (400) feet, together with all equipment and appurtenances necessary to operate said wells and/or complete the drilling thereof. HONOLULU shall remain in possession of said producing wells and wells then in process of drilling, and their respective well sites, together with all necessary equipment and appurtenances, and shall have the right, if it so elects, to complete and operate said wells until [50] such time as HONOLULU shall be reimbursed in full for all expenditures made in the acquisition of said properties and in the operation and development thereof, together with interest thereon, including expenditures made from and after said March 14, 1929, in the development and operation of the wells and well sites retained by HONOLULU, in the

manner above provided in respect to reimbursement of HONOLULU by paragraph 8 hereof.

HONOLULU shall have all necessary rights of way for ingress and egress, roads, water, water lines, pipe lines, and all other necessary appurtenances in the operation of the properties retained by HONOLULU, and shall have a lease and/or assignment of said producing wells and wells in process of drilling, and their respective well sites, and HONOLULU shall have the exclusive operation and control of said producing wells and wells in process of drilling, until such time as HONOLULU shall be reimbursed in full for all expenditures made by HONOLULU, and interest thereon, in the manner above provided.

At the time or in anticipation of the reconveyance of the said properties to ELBE, as in sub-paragraphs (a) or (b) of this paragraph provided, HONOLULU shall not salvage or otherwise dispose of any equipment, appliances, tools and machinery, the cost of which shall have been computed in the [51] said expenditures, for which HONOLULU shall have been reimbursed, as hereinabove provided; and at such time as HONOLULU shall be reimbursed for all expenditures made for or in connection with said properties, as in sub-paragraphs (a) or (b) of this paragraph provided, all equipment, appliances, tools and machinery upon said properties, the cost of which shall have been computed in said expenditures, reimbursement for

which shall have been made to HONOLULU, shall become the property of and title thereto shall vest in ELBE.

On the thirtieth day of each month HONOLULU shall render to ELBE a statement for the preceding calendar month showing the gross expenditures of HONOLULU, for which HONOLULU shall have the right to reimbursement as provided by Paragraph 8, the computation of interest payable by ELBE to HONOLULU hereunder, the volume of production of oil and/or gas and/or derivative products from the said properties and the income therefrom computed in the manner provided for the valuing of oil and/or gas or derivative products, as provided by Paragraph 8 hereof. Upon demand of ELBE, HONOLULU shall render to ELBE an itemized statement of the said expenditures made by HONOLULU for which HONOLULU shall be entitled to reimbursement as provided by Paragraph 8; provided, however, that HONOLULU shall not be obligated to render to ELBE such itemized statement at intervals of less than thirty (30) days.

ELBE shall have the right to examine the books [52] of account of HONOLULU in reference to the operation and development of the properties, the subject of this agreement, at intervals of not less than thirty (30) days and shall have the right, at its sole cost and expense, to have said books of account audited, but not more often than once in any calendar year.

10. HONOLULU shall have the right to surrender at any time the whole of the properties, the subject of this agreement, or any part thereof, or any part of any single lease and/or permit and/or drilling agreement, to ELBE, or, at ELBE'S option, to the original permittee and/or lessor, and upon such surrender HONOLULU shall be released from any and all obligations in respect to the said properties so surrendered, and/or in the payment of any and all royalties resulting from the operation of the said properties so surrendered. From and after such time as HONOLULU shall notify ELBE of the surrender of the properties, the subject of this agreement, or any part thereof, or of any part of any single lease and/or permit and/or drilling agreement, in the event ELBE elects to accept such surrender itself, ELBE assumes and agrees to perform all obligations of any such property, and/or lease and/or permit and/or drilling agreement, or any part thereof, so surrendered, insofar as the performance of said obligations is necessary to protect HONOLULU in the ownership, control, possession, operation and development of the properties, the subject of this agree- [53] ment not surrendered.

11. ELBE agrees to execute any and all deeds, assignments, bills of sale and other instruments of further assurance which may be reasonably required by HONOLULU in order to accomplish the transfer and assignment to HONOLULU of all right, title and interest of ELBE in and to the properties hereinabove mentioned and described, or which may

be reasonably required by HONOLULU in order to accomplish any of the purposes of this agreement.

12. Anything in this agreement contained to the contrary notwithstanding, it is the intention of the parties to this agreement that the full ownership, possession and control of all of the properties, the subject of this agreement, and of all of the personal property acquired and/or used on and in connection with the operation and development of the properties, the subject of this agreement, shall be vested in HONOLULU, and ELBE shall have no interest in or to said properties, or in or to any personal property used on or in connection with the operation or development of the said properties, or in or to the salvage value of any thereof, except as provided by Paragraph 9.

ELBE shall have the right, by its officers or representative, to come upon any of the properties, the subject of this agreement, and examine the same and all the plants, tanks, meters and facilities used in connection with the operation and development thereof; provided, however, that [54] such examination shall be made at the sole cost and expense of ELBE and shall be made in such manner as will least interfere with the operation and development of the said properties.

The payments to be made by HONOLULU to ELBE under and by virtue of the terms hereof, shall be satisfied by deposit of such sums to account of ELBE with California National Bank of Long Beach, Long Beach, California, (or to the account of ELBE with such other bank or trust company

as ELBE may from time to time designate in writing to HONOLULU): and all notices given by HONOLULU to ELBE shall be deposited in the United States mail, postage prepaid, addressed to ELBE at 920 Roxbury Drive, Beverly Hills, California, (or at such other address as may be designated in writing by ELBE to HONOLULU). All notices given by ELBE to HONOLULU shall be deposited in the United States mail, postage prepaid, addressed to HONOLULU, at 215 Market Street, San Francisco, California, (or at such other address as HONOLULU may designate in writing to ELBE). No assignment or assignments, in whole or in part, of any sum or sums to be paid to ELBE hereunder shall entitle ELBE, or any assignee or assignees, to require HONOLULU to make payment other than to California National Bank of Long Beach, California, (or to the account of ELBE with such other bank or trust company as ELBE may from time to time designate in writing to HONOLULU), for the account of ELBE.

13. In the event that the parties to this agreement shall disagree in the interpretation of the meaning of [55] this agreement, or any clause thereof, said parties agree to submit said controversy to arbitration in the manner provided by Part Three, Title Ten of the Code of Civil Procedure of the State of California.

14. This agreement is expressly made assignable, in whole or in part, by the parties hereto.

15. This agreement shall supersede and take the place of any and all other agreements heretofore executed between the parties hereto.

IN WITNESS WHEREOF, the parties hereto have caused this agreement to be executed by their officers thereunto duly authorized, and their corporate seals to be affixed the day and year first above written.

[Seal] ELBE OIL LAND DEVELOPMENT COMPANY

By (s) C. A. WINDHAM
Vice-President

By (s) L. S. BARNES
Secretary

First Party

[Seal] HONOLULU CONSOLIDATED OIL COMPANY

By (s) A. C. DIERICX
President

By (s) ROBT. H. WRIGHT
Asst. Secretary

Second Party [56]

State of California
County of Los Angeles—ss.

On this 28th day of November in the year nineteen hundred and twenty seven, A. D. before me Frieda Segel, a Notary Public in and for the said County of Los Angeles, State of California, residing therein, duly commissioned and sworn, personally appeared C. A. WINDHAM, known to me to be the Vice-President, and L. S. BARNES, known to me to be the Secretary of ELBE OIL LAND DEVELOPMENT COMPANY, the Corporation which executed the within and annexed instrument,

and acknowledged to me that such Corporation executed the same.

IN WITNESS WHEREOF I have hereunto set my hand and affixed my official seal in said county the day and year in this certificate first above wirtten.

(s) FRIEDA SEGEL

Notary Public in and for Los Angeles County, State of California.

State of California
City and County of San Francisco—ss.

On this 29th day of November in the year One Thousand Nine Hundred and Twenty Seven, before me W. W. HEALY, a Notary Public in and for the said City and County, residing therein, duly commissioned, and sworn personally, appeared A. C. DIERICX and ROBERT H. WRIGHT, known to me to be the President and Assistant Secretary of HONOLULU CONSOLIDATED OIL COMPANY, the Corporation described in and that executed the within instrument, and also konwn to me to be the persons who executed the within instrument on behalf of the Corporation therein named, and they duly acknowledged to me that such Corporation executed the same.

IN WITNESS *WHERE,* I have hereunto set my hand and affixed my official seal, at my office in said City and County of San Francisco, the day and year in this Certificate first above written.

[Seal] (s) W. W. HEALEY,

Notary Public in and for the said City and County of San Francisco, State of California.

[Endorsed]: Filed Sept. 18, 1933. [57]

MAP
OF
ROUND MOUNTAIN
OIL FIELD
KERN COUNTY, CAL.

DEPARTMENT OF NATURAL RESOURCES
DIVISION OF OIL & GAS

T 28 S R 28 E

For adjoining Oilfield see Oil Map No. 13, Kern River

Chas. S. Young est.

J. R. Cuttletter

N. B. Smith & C. B. Shelton

Berry Holding Co.

J. Thomas

Vedder Bros. Inc. (U. S. Govt. R.R.)

A. W. Fuhrman

El Portal Mining Co.

W. A. Keating (U. S. Govt. R.R.)

Shell Oil Co.

J. Cutler

Shaw Oil Co.

E. V. McKenzie

U. S. Govt.

A. L. Hyde

Southern Pacific Land Co.

The Kern River Oilfields of California Ltd. (Mortgagee)

Julia Berkowitz

W. T. Wells

D. C. Ferguson

C. T. Wells

D. N. Norbert, Est.

J. C. Cory

T. N. Norbert

Shell Oil Company

Standard Oil Company of Calif. (Lessee)

Union Oil Co.

Petroleum Securities Co.

Associated Oil Co.

Kern River Oilfields of California

Mineral Commission of Cal.

Mineral Petroleum Operations of California

U. S. Govt.

J. A. Whitaker (U. S. Govt. R.R.)

Kern Mining (U. S. Govt. R.R.)

El Portal Mining Co.

Lizzie K. Glide

L. K. Glide

Sec. 3

Sec. 4

Sec. 5

Sec. 7

Sec. 8

Sec. 9

Sec. 10

Sec. 11

Sec. 12

Sec. 13

Sec. 14

Sec. 15

Sec. 16

Sec. 17

Sec. 18

Sec. 19

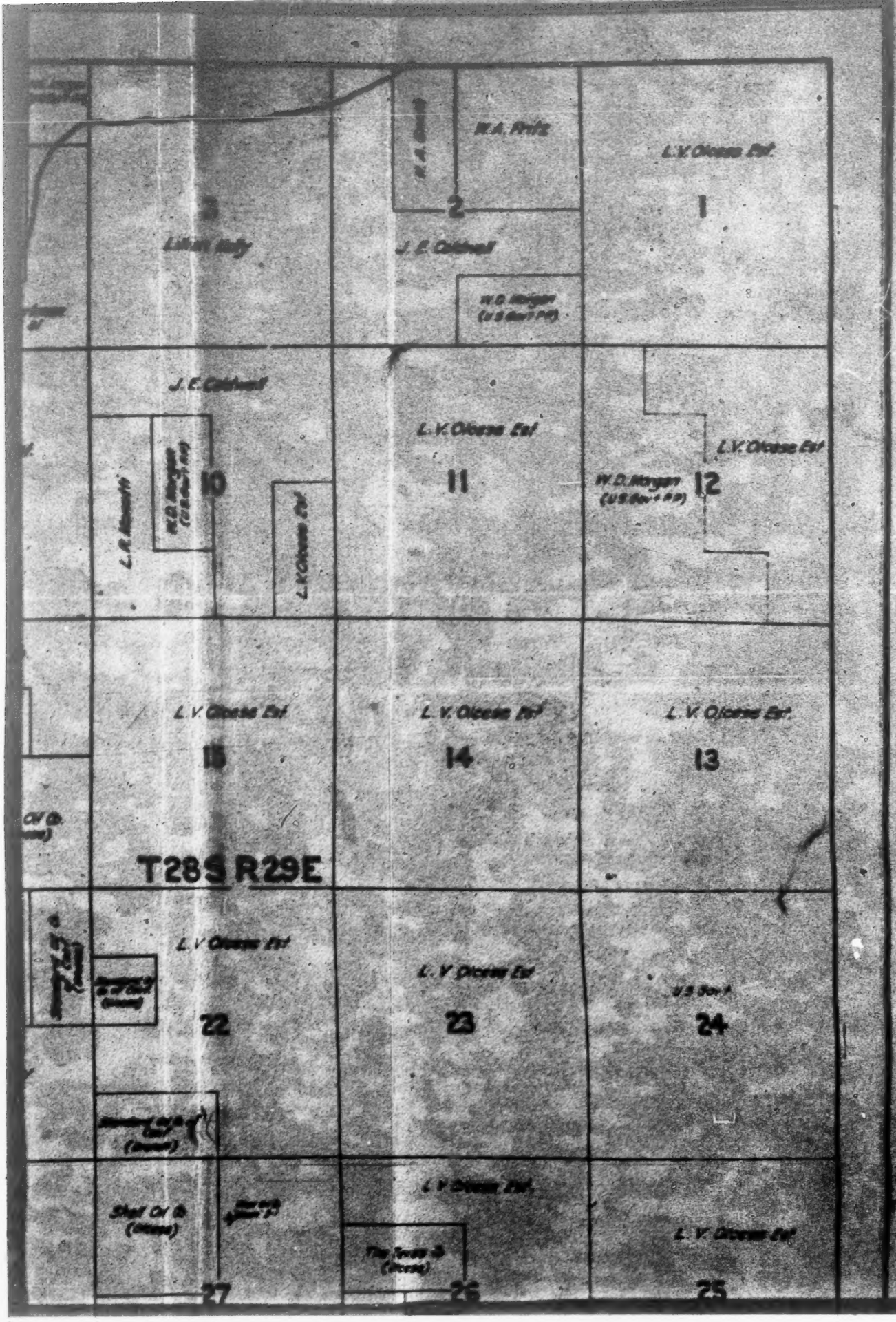
Sec. 23

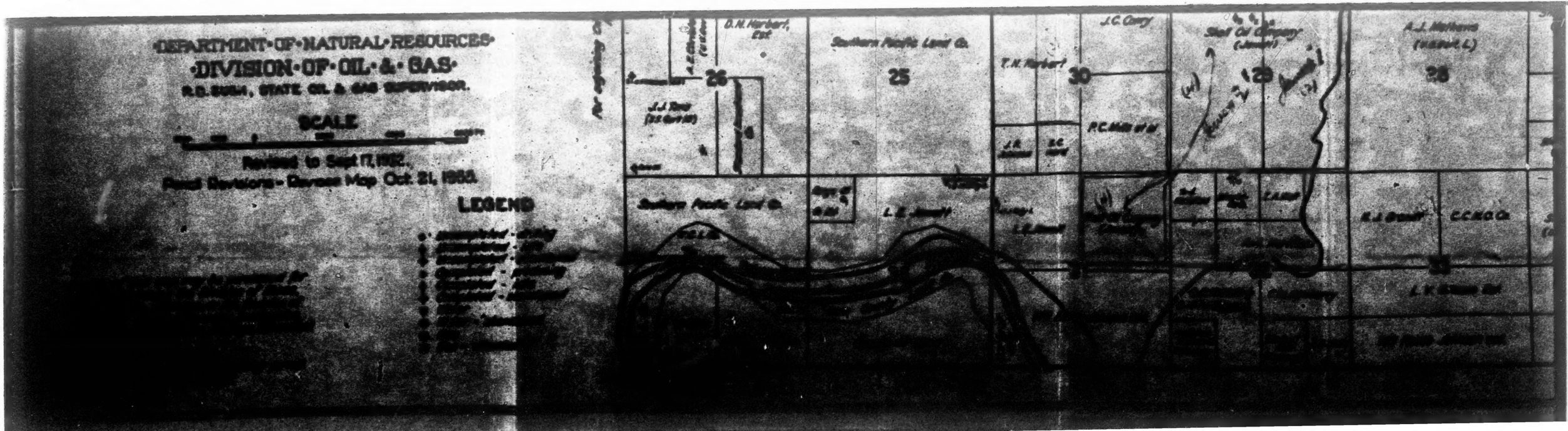
Sec. 24

L. V. Olcese Est.

C. R. & I. R. R. Co.

Kern River


W.A. Fritz
L.V. Olcese Est
1
2
J.E. Gilchrist
J.E. Gilchrist
L.V. Olcese Est
10
11
12
L.V. Olcese Est
L.V. Olcese Est
L.V. Olcese Est
15
14
13
T28S R29E
L.V. Olcese Est
L.V. Olcese Est
U.S. Govt
22
23
24
L.V. Olcese Est
L.V. Olcese Est
27
26
25


DEPARTMENT OF NATURAL RESOURCES
DIVISION OF OIL & GAS
R.D. SMITH, STATE OIL & GAS SUPERVISOR.
SCALE
Revised to Sept 17, 1952.
Field Revisions - Revised Map Oct. 21, 1953.
LEGEND
D.N. Herbert, Etal
Southern Pacific Land Co.
J.C. Carey
Shell Oil Company
A.J. Mathews
25
26
30
29
28
T.N. Herbert

[Title of Court and Cause—Docket No. 54773.]

STIPULATION.

It is hereby stipulated and agreed by and between the above-entitled parties through their respective counsel as follows:

(1) That the map attached hereto, marked exhibit "B" and made a part hereof shows the location of the leases and permits acquired by the Honolulu Consolidated Oil Company from petitioner under the terms of the transfer of October 3, 1927, said acreage being outlined in red and green;

(2) That attached hereto and marked exhibit "C" is a schedule showing the wells drilled by Honolulu Consolidated Oil Company or its assignees, the dates of spudding in, the dates of completion of said wells, and likewise shows those wells which were commercial producers and those which were abandoned.

Said map was prepared as of a date subsequent to the basic date involved herein and there are numerous wells shown thereon which were not begun or completed as of the basic date in this proceeding.

FRED R. ANGEVINE,
Counsel for Petitioner.
(Signed) E. BARRETT PRETTYMAN,
General Counsel,
Bureau of Internal Revenue. [58]

ELBE OIL LAND DEVELOPMENT COMPANY

WELL DATA ON PROPERTIES ACQUIRED BY
HONOLULU OIL CORPORATION, LTD., AND SHELL OIL COMPANY.

	Section	Well No.	Spudded in	Completed	Remarks
		HONOLULU OIL CORPORATION, LTD.			
LEASE NO. 019840:	20-28-29	1A	11/10/27	1/21/28	
	20-28-29	2	1/15/27	5/31/27	
	20-28-29	3	1/ 6/28	3/14/28	
	20-28-29	100	2/ 1/28		Abandoned 5/20/31
	20-28-29	940	2/ 9/28		Abandoned 4/17/28
	20-28-29	3A	8/18/30	10/18/30	
LEASE NO. 019847:	18-28-29	36	10/ 8/27	3/ 8/28	
LEASE NO. 019848:	18-28-29	68	10/10/27	2/22/28	
	18-28-29	99	5/ 5/30	7/31/30	
LEASE NO. 019845:	18-28-29	44	1/21/28	4/25/28	
LEASE NO. 019847:	18-28-29	14	1/23/28	5/18/28	

Comm'r of Int. Revenue

	Section	Well No.	Spudded in	Completed	Remarks
		SHELL OIL COMPANY			
JEWETT LEASE NO. 1:	29-28-29	3	6/ 6/28		Abandoned 9/12/28
	29-28-29	13	7/15/30	8/ 3/30	
JEWETT LEASE NO. 2:	29-28-29	1	12/ 8/27	1/19/28	
	29-28-29	2	2/23/28	5/13/28	
	29-28-29	4	9/19/28	11/23/28	
	29-28-29	5	2/ 5/29	3/ 7/29	
	29-28-29	6	4/29/29	5/28/29	
	29-28-29	7	8/11/29	9/24/29	
	29-28-29	8	9/13/29	10/16/29	
	29-28-29	9	1/ 6/30	2/25/30	
	29-28-29	10	11/25/29	1/ 5/30	
	29-28-29	11	3/20/30	4/17/30	
	29-28-29	12	5/20/30	6/19/30	
	29-28-29	14	9/28/30	10/29/30	
FREEMAN LEASE:	20-28-29	1	5/20/28	7/29/28	
	20-28-29	2	11/11/28	1/ 4/29	
	20-28-29	3	2/ 1/29	3/29/29	
	20-28-29	4	4/ 6/29	6/18/29	
	20-28-29	5	11/ 3/29	11/27/29	
	20-28-29	6	10/12/27		Suspended 3/8/28
	20-28-29	7	2/18/30	3/15/30	
	20-28-29	8	6/12/30	7/ 8/30	
	20-28-29	9	10/11/30	10/26/30	

[Endorsed]: Filed Jan. 30, 1934.

[Title of Court and Cause.]

Docket Nos. 54773, 60157.

Promulgated April 14, 1936.

Depletion—Oil & Gas Wells.—In 1927 petitioner under a contract of sale, conveyed its interest in certain leases, permits, drilling agreements, and all of the oil and gas produced from the properties to another corporation in consideration for cash payments to be made in the years 1927 to 1931, inclusive, totaling $2,000,000 (all of which has been paid), and in addition thereto the promise of future payments of one-third of the latter's net profits wholly contingent upon the happening of indeterminable events which had not occurred up to the year 1933. Held, that the cash payments received by petitioner in the years 1928 and 1929 constituted proceeds from the sale of a capital asset and were not gross income from the property within the meaning of that phrase as used in section 114 (b) (3) of the 1928 Act and therefore are not subject to a percentage allowance for depletion.

FRED R. ANGEVINE, Esq., W. L. E. O'BRYAN, Esq., and C. WM. WITTMAN, C. P. A., for the petitioner.

ELDEN McFARLAND, Esq., for the respondent.

OPINION.

TYSON: These consolidated proceedings seek redetermination of income tax deficiencies in the

amounts of $16,626.09 for the year 1928 and $12,-149.50 for the year 1929, asserted by respondent as the result of several adjustments made by him in the income reported by petitioner for those years. All issues, except one, have been waived or stipulated, and effect thereto will be given upon the recomputation under Rule 50. The stipulation of facts and exhibits attached thereto are included herein by reference.

The sole remaining issue, as to both years, involves the question of whether petitioner is entitled to a deduction of $110,000 for depletion at the rate of 27½ percent of a $400,000 payment received in each of those years under the terms of a written contract relative to certain oil and gas properties, executed on October 3, 1927. [61]

Petitioner, a California corporation, was organized on February 4, 1924. It acquired certain properties consisting of oil and gas prospecting permits, drilling agreements, leases, and equipment. Development work carried on by it resulted in the discovery of oil on its properties and on October 3, 1927, oil was being produced in commercial quantities.

As of October 3, 1927, under the terms of the written contract executed on that date, the petitioner sold, transferred, and conveyed all of its right, title, and interest in and to certain described prospecting permits, drilling agreements, leases, and equipment, unto the Honolulu Consolidated Oil Co., a California corporation, the latter to "have the sole ownership of and the right to sell or otherwise dispose of, all oil and/or gas and derivative products produced in,

on or upon said properties", it being "the intention of the parties to this agreement that the full and complete ownership, control and operation of said properties shall vest, upon execution hereof, in Honolulu * * * and Elbe shall have no interest in or to any of said properties whatsoever." The consideration to be paid petitioner, as set forth in paragraph 7 of said contract, was $350,000 cash upon the execution of the contract and thereafter, if the Honolulu Consolidated Oil Co. did not elect to abandon the purchase of the properties and execute reconveyances as provided by paragraph 9 of the contract, the sum of $400,000 on the 14th day of March of each of the years 1928, 1929, and 1930 and $450,000 on March 14, 1931, together with interest as specified. Of such $2,000,000 to be received by petitioner in cash and notes, the amount of $1,963,672.95 was consideration for the oil and gas rights in the leases and the remainder was consideration for equipment and other property conveyed. The stated consideration for such sale was fixed at the definite amount of $2,000,000, to be paid without reference to, and without being in any manner based upon, the production of oil from the properties conveyed.

The petitioner has received each of the payments, in the amounts and on the dates specified in the contract, totaling $2,000,000. The cost of all of the assets transferred under the contract was less than the amount of $350,000 received in 1927 and for that year petitioner reported a taxable gain, from the transaction, by applying the entire basis against the $350,000. In its returns for 1928 and 1929 peti-

tioner claimed the deduction herein sought for depletion on the ground that the payment of $400,000 received in each of those years constituted a bonus on a sublease.

The contract, in paragraph 8 thereof, provided that, "from and after the time" when the Honolulu Consolidated Oil Co. should have been fully reimbursed from its sales of oil and gas produced from [62] the properties, for all expenditures made in the acquisition, development, and operation thereof, it should pay to petitioner 33 1/3 percent of its net profits, as defined in the contract, resulting thereafter from the continued production, if any, from the properties.

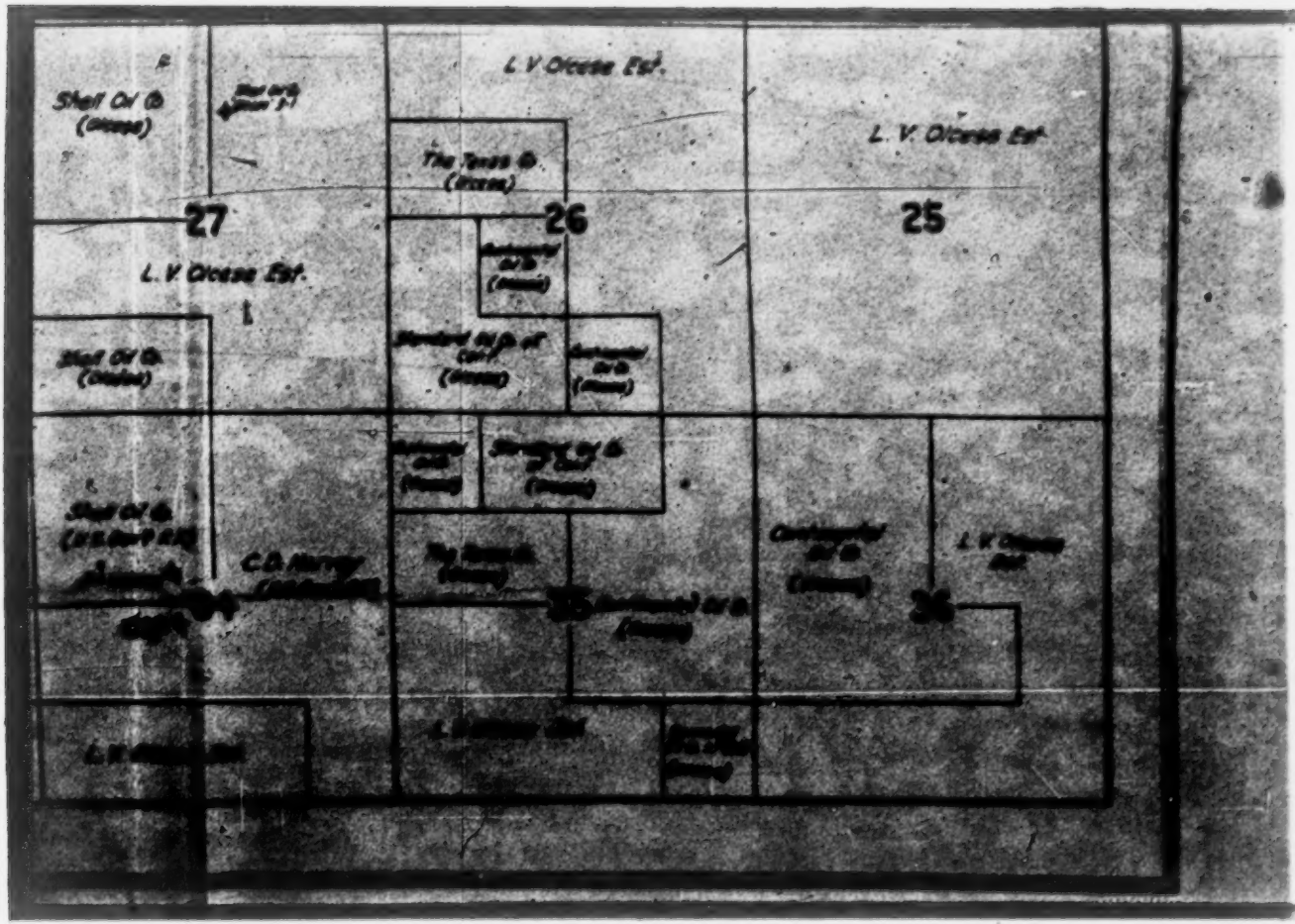
During the years here in controversy, and up to the date of hearing herein in September 1933, no payments became due or were made to petitioner by the Honolulu Consolidated Oil Co. upon the latter's wholly contingent obligation for future payments under its contract of purchase. Such contingent obligation of the Honolulu Consolidated Oil Co. is separate and apart from its obligation for the payments totaling $2,000,000 and does not impart to such payments the character of being income realized from the retention by petitioner of an economic interest in the oil and gas produced during the period covered by such payments. We do not have before us the question of the character of such future payments if and when made or whether or not they might be subject to depletion under the then applicable revenue acts.

Therefore, the only issue now before us involves the question of whether, under the provisions of section 114 (b) (3) of the Revenue Act of 1928,[1] petitioner is entitled to a deduction of 27½ percent of $400,000 for each of the years 1928 and 1929, as an "allowance for depletion * * * of the gross income from the property during the taxable year."

Petitioner contends that this proceeding is controlled by the decision in Palmer v. Bender, 287 U. S. 551. In that case the taxpayer was the member of two partnerships which in 1921 executed writings by which it "does sell, assign, set over, transfer and deliver * * * unto the Ohio Oil Co." certain leased premises in consideration of a present payment of a cash bonus, future payments to be made "out of one-half of the first oil produced and saved" to the extent of a specified sum and an additional excess royalty of one-eighth of ALL oil produced and saved. The District Court and the Circuit Court held that the transaction constituted a sale of a capital asset, that no interest was retained in the oil and gas, and that the taxpayer was not entitled to depletion. The taxpayer in the Palmer case, supra,

[1]Sec. 114 (b). BASIS FOR DEPLETION.

(3) Percentage Depletion for Oil and Gas Wells.—In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.


L. V. Ocean Est.
L. V. Ocean Est.
27
26
25
L. V. Ocean Est.

contended that the instrument was a lease and invoked the rule in Murphy Oil Co. v. Burnet, 278 U. S. 299, that a lessor is entitled to a depletion allowance on both bonus (advance royalties) and royalties. The Supreme Court held that it was immaterial whether the [63] instrument constituted a sale, an assignment or a lease; that the question involved merely the application of section 214 (a) (10) of the Revenue Act of 1921, which provided for a deduction of a reasonable allowance for depletion "in the case of * * * oil and gas wells, * * * according to the peculiar conditions in each case"; that the language of the section did not restrict such allowance "to any particular class or to any special form of legal interest in the oil well", but is broad enough to include "every case in which the taxpayer has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital", whether the taxpayer be vendor, lessor, lessee, or their transferee, so long as by the terms of the transaction involved the taxpayer retains "a right to share in the oil produced", that is, "an economic interest in the oil, in place, which is depleted by production." The Supreme Court decided that "when the two lessees (partnerships) transferred their operating rights to the two oil companies, whether they became technical sublessors or not, they retained, by their stipulations for royalties, an economic interest in the oil, in place, identical with that of a lessor", and because of this retention

of an economic interest through the medium of royalties was, to the extent of such interest, entitled to a reasonable allowance for depletion. The ground upon which the opinion in the Palmer case, supra, was based, was the retention of an economic interest by the taxpayer of the oil in place. The holding in that case then is not crontrolling in the instant case because the taxpayer herein retained no economic interest in the oil in place, so far as the payments here in controversy are concerned.

The contract of October 3, 1927, constituted an absolute sale of not only its interest in the leases, permits, and drilling agreements transferred, which might be termed operating agreements, but also ALL of the oil and gas in place, for the contract specifically provided that the Honolulu Consolidated Oil Co. acquired "the sole ownership of and the right to sell or otherwise dispose of, ALL oil and/or gas and derivative products produced in, on or upon said properties" and further that the petitioner "shall have no interest in or to any of said properties whatsoever." The consideration in the definite amount of $2,000,000 was not in any way dependent upon the production of oil from the properties. It is therefore obvious that the petitioner did not retain any economic interest or investment in the oil and gas, in place, so far as the payments here in controversy are concerned, subject to depletion on extraction, but looked only to the independent personal liability of the purchaser for the receipt of [64] the agreed purchase price of $2,000,000 pursuant to the terms of the contract of sale.

We conclude that the cash payments of $400,000 received by petitioner in each of the years 1928 and 1929 constituted proceeds from the sale of a capital asset and were not gross income from the property within the meaning of that phrase as used in section 114 (b) (3), supra, and therefore petitioner is not entitled to a depletion allowance of 27½ percent thereof under the provision of that section. William Fleming, 31 B. T. A. 623; affd.,—Fed.(2d)—(C. C. A., 5th Cir., March 11, 1931); and E. F. Simms, 28 B. T. A. 988, 1028, 1029. Cf. Comar Oil Co., 24 B. T. A. 688; affd., 64 Fed(2d) 965; certiorari denied, 290 U. S. 652. Decision will be entered under Rule 50. [65]

United States Board of Tax Appeals.
Washington, D. C.

Docket Nos. 54773, 60157.

ELBE OIL LAND DEVELOPMENT COMPANY,
Petitioner.

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DECISION.

Pursuant to the Board's Opinion promulgated April 14, 1936, in the above entitled proceeding, the respondent having duly filed a proposed recomputation in accordance therewith, and the petitioner

having failed, after due notice, to file a counter proposed recomputation or to object, at the hearing on May 27, 1936, to the recomputation as made by respondent, it is hereby

ORDERED AND DECIDED that there is a net loss in the amount of $32,833.68 for the calendar year 1927 and that there are income tax deficiencies in the amounts of $14,327.13 and $12,149.50 for the calendar years 1928 and 1929, respectively.

[Seal] (Signed) JOHN A. TYSON,
Member.

Entered Jun. 2, 1936. [66]

[Title of Court and Cause.]

Docket Nos. 54773, 60157.

PETITION OF ELBE OIL LAND DEVELOPMENT COMPANY FOR REVIEW BY THE CIRCUIT COURT OF APPEALS OF THE UNITED STATES FOR THE NINTH CIRCUIT OF A DECISION BY THE UNITED STATES BOARD OF TAX APPEALS.

Elbe Oil Land Development Company, the petitioner in this cause, by George T. Altman, counsel, hereby files its petition for a review by the Circuit Court of Appeals of the United States for the Ninth Circuit of the decision by the United States Board of Tax Appeals rendered on June 2, 1936, 34 B. T. A. ....., No. 55, determining deficiencies in the petitioner's Federal income taxes for the years 1928 and 1929, in the respective amounts of $14,327.13 and $12,149.50, and respectfully shows:

I.

The petitioner, Elbe Oil Land Development Company, is a corporation organized and existing under and by virtue of the laws of the State of California, with its principal office in Los Angeles, California.

II.

Nature of the Controversy.

Prior to October 3, 1927 the petitioner had acquired certain properties consisting of oil and gas prospecting permits, drilling agreements, leases, and equipment. Development work carried on by it resulted in the discovery of oil on its properties and on October 3, 1927, oil was being produced in commercial quantities. On that date petitioner transferred the said [67] prospecting permits, drilling agreements, leases, and equipment, under the terms of a written contract. That contract is a part of the record made before the Board aud is incorporated by reference in the opinion of the Board. The controversy involves the legal effect of that contract with respect to the deduction for depletion, the question being whether petitioner was entitled to deduct percentage depletion at 27½ percent, under Section 114 (b) (3) of the Revenue Act of 1928, on the amounts received under that contract in 1928 and 1929. There is no other issue.

By that contract petitioner transferred the said prospecting permits, drilling agreements, leases, and equipment, to the Honolulu Consolidated Oil Company, a California corporation (hereinafter referred to as Honolulu), under the following terms:

(1) Honolulu agreed to pay to petitioner the sum of $350,000 on execution of the contract.

(2) On or before March 14, 1928, Honolulu might elect to transfer back to petitioner all of said properties (except producing wells and wells in process of drilling, which it might retain until reimbursed for all of its expenditures).

(3) If Honolulu did not so elect, then on March 14, 1928, it was required to pay petitioner the further sum of $400,000.

(4) After said payment and on or before March 14, 1929, Honolulu might again elect to transfer back to petitioner all of said properties (except, again, producing wells and wells in process of drilling, which it might retain until reimbursed for all of its expenditures).

(5) If Honolulu did not so elect then it was required to pay petitioner on March 14, 1929, the further sum of $400,000; and on March 14, 1930, the further sum of $400,000; and on March 14, 1931, the further sum of $450,000; [68] interest being added at 2½ per cent from March 14, 1929.

(6) Honolulu agreed to perform all work and labor required under the permits and leases transferred to it, and to pay the royalties required thereunder to the United States, the original permittees, and the original lessors provided, however, that Honolulu might surrender to petitioner the properties or any part thereof, and be thereupon released of the said obligation assumed with respect thereto.

(7) After Honolulu should be reimbursed for its expenditures under the contract and in operation of the properties (said reimbursement to be determined not by actual sales, but by the current market price of the oil and gas produced), then Honolulu thereafter was required to pay petitioner, monthly, one-third of the net profits from the properties.

(8) Honolulu was required to render monthly statements of operations to petitioner, with right in the petitioner to examine the books of Honolulu and to have audits made of them, and to come upon and examine the properties at any time.

The payment of $400,000 indicated above as being required to be made on March 14, 1928, was made on that date; and the payment of $400,000 indicated above as being required to be made on March 14, 1929 was made on that date. Petitioner deducted on its returns 27½ per cent, or $110,000, with respect to each of said payments received, under the provisions of Section 114 (b) (3) of the Revenue Act of 1928. The Commissioner of Internal Revenue disallowed those deductions, holding that the petitioner did not retain under the contract an economic interest in the oil, in place, which is depleted by production, so far as the payments in controversy were concerned; and the Board sustained the Commissioner. [69]

III.

The said Elbe Oil Land Development Company, being aggrieved by the conclusions and opinion of the Board, and by its decision entered pursuant

thereto, desires to obtain a review thereof by the Circuit Court of Appeals of the United States for the Ninth Circuit.

IV.

Assignments of Error.

The petitioner assigns as error the following acts and omissions of the Board of Tax Appeals:

(1) The failure to allow as a deduction the amount of $110,000 as percentage depletion for each of the years 1928 and 1929.

(2) The holding that the contract hereinbefore described constituted an outright sale of the properties covered thereby.

(3) The holding that the petitioner did not retain under said contract an interest in the oil, in place, which is depleted by production, so far as the payments received in 1928 and 1929 are concerned.

(4) The attempted separation of the said contract into two contracts, one in effect a sale (the part with reference to the stated sums to be paid) and the other in effect a sublease (the part with reference to the percentage of profits reserved), although both parts cover the same identical properties and there was but one transaction.

(5) The failure to conclude that the amounts paid to petitioner in 1928 and 1929 were in effect only bonus or minimum royalties.

(6) The failure to conclude that the contract described did not create an unconditional obligation on the part of the transferee of the properties to pay either of said amounts, but only an obliga-

tion to pay said amounts if it did not elect, on or before the dates, respectively, when payment was to [70] be made, to transfer the properties involved back to the petitioner.

(7) The failure to conclude that the contract described did not create an unconditional obligation to pay any purchase price or any amount except the initial amount paid on the execution of the contract in 1927.

(8) The determination of the nature of the contract from the surplusage of recitals of intention (omitting therefrom material restrictive clauses), instead of from the clauses indicating what the parties were actually obligated to do and entitled to do.

(9) The finding of deficiencies for the years 1928 and 1929 in lieu of a determination that there is no income tax due from the petitioner for any of the years in controversy.

(s) GEORGE T. ALTMAN
Counsel for Petitioner,
10 South LaSalle Street,
Chicago, Illinois.

State of Illinois,
County of Cook—ss:

George T. Altman, being first duly sworn, says that he is counsel of record in the above-named cause; that as such counsel he is authorized to verify the foregoing petition for review; that he has read the said petition and is familiar with the state-

ments contained therein; and that the statements made are true to the best of his knowledge, information and belief.

(s) GEORGE T. ALTMAN.

Subscribed and sworn to before me this 26th day of August, 1936.

[Seal] (s) HOMER R. HOPPS,
Notary Public.

[Endorsed]: Filed Aug. 27, 1936. [71]

[Title of Court and Cause—Docket Nos. 54773, 60157.]

PRAECIPE FOR RECORD.

To the Clerk of the United States Board of Tax Appeals:

You are hereby requested to prepare and certify and transmit to the Clerk of the United States Circuit Court of Appeals for the Ninth Circuit, with reference to petition for review heretofore filed by the petitioner in the above cause, a transcript of the record in the above cause, prepared and transmitted as required by law and by the rules of said Court, and to include in said transcript of record the following documents or certified copies thereof, to-wit:

(1) The docket entries of all proceedings before the Board of Tax Appeals.

(2) Pleadings before the Board of Tax Appeals, as follows:

(a) Petition for redetermination in Docket No. 54773.

(b) Answer of the Respondent in Docket No. 54773.

(c) Petition for redetermination in Docket No. 60157.

(d) Answer of the Respondent in Docket No. 60157.

(3) Stipulation filed by the parties on September 18, 1933, including Exhibit attached thereto.

(4) Stipulation filed by the parties on January 30, 1934, including Exhibits attached thereto.

(5) Opinion of the Board of Tax Appeals.

(6) The Decision of the Board.

(7) The Petition for review, filed by the petitioner in the above cause.

(8) This Praecipe.

Respectfully,

GEORGE T. ALTMAN

Counsel for Petitioner.

10 South LaSalle St.,

Chicago, Ill.

[Endorsed]: Filed Oct. 2, 1936. [72]

[Title of Court and Cause.—Docket Nos. 54773, 60157.]

CERTIFICATE.

I, B. D. Gamble, clerk of the U. S. Board of Tax Appeals, do hereby certify that the foregoing pages, 1 to 72, inclusive, contain and are a true copy of the transcript of record, papers, and proceedings on file and of record in my office as called for by the Praecipe in the appeal (or appeals) as above numbered and entitled.

In testimony whereof, I hereunto set my hand and affix the seal of the United States Board of Tax Appeals, at Washington, in the District of Columbia, this 12th day of Oct., 1936.

[Seal] B. D. GAMBLE,
Clerk,
United States Board of Tax Appeals.

[Endorsed]: No. 8358. United States Circuit Court of Appeals for the Ninth Circuit. Elbe Oil Land Development Company, Petitioner, vs. Commissioner of Internal Revenue, Respondent. Transcript of the Record. Upon Petition to Review an Order of the United States Board of Tax Appeals.

Filed October 20, 1936.

PAUL P. O'BRIEN,
Clerk of the United States Circuit Court of Appeals for the Ninth Circuit.

UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

No. 8358

ELBE OIL LAND DEVELOPMENT COMPANY, PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Upon Petition to Review a Decision of the United States Board of Tax Appeals

Excerpt from Proceedings of Tuesday, April 13, 1937

Before WILBUR, GARRECHT, and HANEY, Circuit Judges

Order of submission

Ordered above cause argued by Mr. George T. Altman, counsel for petitioner, and by Mr. Lester L. Gibson, Special Assistant to the Attorney General, counsel for respondent, and submitted to the court for consideration and decision.

Excerpt from Proceedings of Monday, June 21, 1937

Before WILBUR, DENMAN, and MATHEWS, Circuit Judges

Order directing filing of opinions and filing and recording of judgment

By direction of the court, ordered that the opinion, concurring opinion, and dissenting opinion this day rendered by this court in above cause be forthwith filed by the clerk, and that a judgment be filed and recorded in the minutes of this court in accordance with the opinion and concurring opinion.

In the United States Circuit Court of Appeals for the Ninth Circuit

No. 8358. June 21, 1937

ELBE OIL LAND DEVELOPMENT COMPANY, PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Upon Petition to Review Decision of the United States Board of Tax Appeals

Before WILBUR, GARRECHT, and HANEY, Circuit Judges

WILBUR, *Circuit Judge:* In each of the taxable years 1928 and 1929 the petitioner received the sum of $400,000, being payments under an agreement with the Honolulu Consolidated Oil Company

(hereinafter called the Honolulu Company), with reference to the transfer of a large area of oil lands, the exact nature and effect of this agreement being the subject of this controversy.

The petitioner claims that it is entitled to a depletion allowance of 27½ per cent from each of these two payments by reason of the fact that it had retained an economic interest in the oil in the lands in question, while the Commissioner contends that these two items represent payments of the purchase price of the sale of the lands and, consequently, that no depletion allowance was permissible under the statute, particularly in view of the fact that a previous payment made in 1928 of $350,000 more than covered the cost of the property to the petitioner, the cost had been allowed as deduction in estimating its taxable gain derived from the payment.

The Board of Tax Appeals was largely influenced in its decision that the transaction constituted a sale by the fact that the agreement between the petitioner and the Honolulu Company expressly provided that all the right, title, and interest of the petitioner in the leases and permits upon the government land in question was conveyed to and vested in the Honolulu Company. Petitioner, however, contends that on consideration of the entire agreement, its scope and effect, it will appear that it had retained an economic interest in the oil and was therefore entitled to a depletion allowance from the cash payments received by it. The instrument under which the two payments were made may be briefly summarized as follows:

By the terms of the agreement an initial payment of $350,000 was made in 1927. This was to be followed in the years 1928 and 1929 by payments of $400,000 on the 15th day of March of each year. The Honolulu Company was to take possession of the property and drill for oil, as required by the various leases and permits which were assigned to it by the petitioner. It reserved the right, however, to surrender the property without making the payment of 1928, or, after that payment, before making the payment of 1929, if it so desired. However, in the event of such surrender or reconveyance as it is styled in the instrument in question, the Honolulu Company retained the right to the possession of all oil wells which had been completed or were in the process of drilling until such time as it had been reimbursed for all its expenditures and all payments it had made to the petitioner. If the Honolulu Company did not surrender the property before the 14th of March 1929, it agreed to continue payments aggregating in all $2,000,000. After its payments were completed no further sums were to be paid to the petitioner until the Honolulu Company had been reimbursed for all payments and expenditures it had incurred in connection with the property, including the $2,000,000 paid, and thereafter the petitioner was to receive one-third of all oil produced. It is difficult to distinguish the situation thus presented from the case of an ordinary lease providing for bonus payments and royalties so frequently dealt with

in the decisions involving the right to a depletion allowance for income tax purposes.

It is apparent that the whole contract was based upon the value of the oil content of the land. The payments made to the petitioner in 1928–1929 were optional with the Honolulu Company which, prior to that time, was in possession of the property and developing its oil resources. In the event the land proved valueless there was no obligation on the part of the Honolulu Company to pay $400,000. If payment was made it is clear that it was only because of the belief that development of the oil resources of the land justified such payment. Here it should be added that the agreement in question provided that the Honolulu Company could surrender any of the leases or leased land covered by the contract after notice to the petitioner and without incurring any liability because of such surrender.

The decision of the Supreme Court in Palmer v. Bender, 287 U. S. 551, dealt with a somewhat similar situation. There the owner of certain oil leases transferred the leased property in consideration of a cash bonus and the future payment to be made out of the oil produced to the extent of $1,000,000, plus a royalty of one-eighth of all the oil produced and saved. The instrument purported to be a sale. The Commissioner refused to permit a depletion allowance to the seller, upon the theory that the transaction was a sale and that the purchaser must take his capital return by deduction of the cost from the sale price. The contention was made that under the law of Louisiana the so-called sale was in legal effect an assignment or sublease. The court, however, took the broad view that this was entirely immaterial. The question of whether or not depletion allowance should be given was to be determined by the Revenue Act. We quote from the opinion in that regard as follows:

"Nothing in Sec. 214 (a) (10) [concerning depletion allowance] indicates that its application is to be controlled or varied by any particular characterization by local law of the interests to which it is to be applied. See Burnet v. Harmel, ante, p. 103 (287 U. S.). We look to the statute itself and to the decisions construing it to ascertain to what interests it is to be applied and then to the particular interests secured to the two partnerships [who had transferred their oil leases] by the instruments in question to ascertain whether they come within the statutory provision. The formal attributes of those instruments or the descriptive terminology which may be applied to them in the local law are both irrelevant. * * *

"Similarly, the lessor's right to a depletion allowance does not depend upon his retention of ownership or any other particular form of legal interest in the mineral content of the land. It is enough if, by virtue of the leasing transaction, he has retained a right to share in the oil produced. If so, he has an economic interest in the oil, in place, which is depleted by production. * * *

"When the two lessees transferred their operating rights to the two oil companies, whether they became technical sub-lessors or not, they retained, by their stipulations for royalties, an economic in-

terest in the oil, in place, identical with that of a lessor. * * * The loss or destruction of the oil at any time from the date of the leases until complete extraction would have resulted in loss to the partnerships. Such an interest is, we think, included within the meaning and purpose of the statute permitting deduction in the case of oil and gas wells of a reasonable allowance for depletion according to the peculiar conditions in each case."

The respondent strongly relies upon our decision in Elliott Petroleum Corp. v. Comm'r, 82 F. (2) 193, decided March 9, 1936, and upon a decision of the Circuit Court of Appeals for the Fifth Circuit, Fleming v. Comm'r, 82 F. (2d) 324, decided March 7, 1936.

In the case before us (Elliott Petroleum Corp. v. Comm'r, supra) the question at issue was whether or not in the sale of an oil lease for cash and for a fixed balance payable out of the net proceeds of oil production from the lease sold, the taxpayer (vendor) was entitled to a depletion allowance upon the payments to it derived from the oil produced from the land where it had already been permitted to deduct the entire cost for the land from the cash payment theretofore made in estimating the taxable income. We sustained the holding of the Board of Tax Appeals that the vendor had an economic interest in the oil in place which entitled it to a share in the depletion allowance. We expressly refrained from passing upon the question of whether or not the Commissioner had properly allowed the entire cost of the property as a deduction from the cash payment in estimating the taxable income therefrom, deciding only that so far as the payments derived from the oil were concerned there was a right of depletion where the payment was contingent upon the recovery of sufficient oil to pay the amount due. We thus reserved the very question which is involved in the case at bar, namely, the amount and character of the deduction allowable from the cash payments in such a transaction.

In Fleming v. Comm'r, supra, a similar question was presented. The cash payment was $1,000,000, and a second million was to be paid from the proceeds of the oil derived from the premises. It was held by a majority of the court that the seller of the land was not entitled to a depletion deduction from the $1,000,000 in cash which he had received, but that he was entitled to a deduction from the payments derived from "one-fourth of all the oil, gas, and other minerals produced", etc. Circuit Judge Foster dissented upon the ground that under the decision of the Supreme Court in Palmer v. Bender, supra, there should also be a deduction for depletion on cash payment "since the taxpayer retains an economic interest in the oil in place." The opinion of the majority in that case called attention to the fact that in Texas "oil and gas in the ground are capable of ownership and sale separate from the soil which contains them, and leases such as are here involved convey to the lessee title to the oil and gas." The court said:

"While the contract was phrased as though the lease and all the oil were sold, and as though the proceeds were to be paid back to the

seller, the real essence of the transaction was that the lease was sold and all the oil except that whose proceeds were to come to the selling taxpayer. * * * The thing sold for the cash consideration was the lease and all the oil except that so reserved." Under the law of Texas, as the court states, oil in place can be sold. While the court expressly declared that the law of Texas was not controlling, the idea of a sale of the land and three-fourths of the oil content, and a reservation of one-fourth of the oil content (up to $1,000,000) was the determining factor in the decision that the $1,000,000 paid outright as consideration for the sale was to have no depletion allowance, only a deduction for cost, and that the money payable only from the oil produced should have a depletion allowance of 27½%.

If the case at bar cannot be distinguished from the decision of the Fifth Circuit Court of Appeals in Comm'r. v. Fleming, supra, because of the fact that the two $400,000 payments involved here were to be optional with the purchaser, and thus were obviously dependent upon the result of exploratory operations for oil, and because of the fact that the vendee had the right to surrender the premises at any time before the payment of the second $400,000, as the Commissioner contends it can be distinguished, we must then decline to follow that decision. In the case at bar it is entirely clear that no matter what language we use in describing the nature of the transaction between the petitioner and the Honolulu Company, the petitioner had at all times an economic interest in the oil produced from the leased premises and was therefore entitled to a depletion allowance upon the cash paid as well as the oil produced. It was in effect a guarantee of future oil production and made because of such anticipated production, and upon an express agreement that the Honolulu Company was to be reimbursed therefrom before the taxpayer received its royalty payments. It was entitled to a depletion allowance under the Revenue Act of 1928, Sec. 114 (d) (3). (Herring v. Comm'r, 293 U. S. 322).

Reversed.

HANEY, Circuit Judge, Concurring.

I concur in the holding that depletion deduction must be here allowed, solely on the ground that although Palmer v. Bender, 287 U. S. 551 is distinguishable on its facts, the language used therein is general enough to embrace the facts herein.

GARRECHT, Circuit Judge, dissenting:

The majority of the court in reversing the order of the Board of Tax Appeals rely upon the decision of the Supreme Court in Palmer v. Bender, 287 U. S. 551.

In that case the taxpayer very definitely had an economic interest in the oil and taxes were assessed on payments made from oil produced, but here the payments taxed were made in cash and were not dependent upon the production of oil.

The gross income from the property which is subject to the depletion allowance is the gross income from the oil and gas produced. Helvering v. Twin Bell Syndicate, 293 U. S. 312. Here the payments subjected to the tax did not depend upon production but were pay-

able in any event. Commissioner of Internal Revenue v. Fleming, 82 F. (2d) 324.

The order of the Board of Tax Appeals should be sustained.

(Endorsed:) Opinion, Concurring and Dissenting Opinion. Filed June 21, 1937. Paul P. O'Brien, Clerk.

United States Circuit Court of Appeals for the Ninth Circuit

No. 8358

ELBE OIL LAND DEVELOPMENT CO., PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Upon Petition to Review a Decision of the United States Board of Tax Appeals

Judgment

This Cause came on to be heard on the Transcript of the Record from the United States Board of Tax Appeals and was duly submitted.

On Consideration Whereof, it is now here ordered and adjudged by this Court, that the Decision of the said Board of Tax Appeals in this Cause be, and hereby is reversed.

(Endorsed:) Judgment. Filed and entered June 21, 1937. Paul P. O'Brien, Clerk.

Certificate of Clerk, U. S. Circuit Court of Appeals for the Ninth Circuit, to record certified under Rule 38 of the Revised Rules of the Supreme Court of the United States

I, Paul P. O'Brien, as Clerk of the United States Circuit Court of Appeals for the Ninth Circuit, do hereby certify the foregoing ninety-five (95) pages, numbered from and including 1 to and including 95, to be a full, true, and correct copy of the entire record of the above-entitled case in the said Circuit Court of Appeals, made pursuant to request of Hon. Stanley Reed, Solicitor General of the United States, of counsel for the respondent, and certified under Rule 38 of the Revised Rules of the Supreme Court of the United States, as the originals thereof remain on file and appear of record in my office.

Attest my hand and the seal of the said the United States Circuit Court of Appeals for the Ninth Circuit, at the City of San Francisco, in the State of California, this 10th day of September, A. D. 1937.

[SEAL]

PAUL P. O'BRIEN, *Clerk.*
By FRANK H. SCHMID, *Deputy Clerk.*

U. S. GOVERNMENT PRINTING OFFICE: 1937

Supreme Court of the United States

Order allowing certiorari

Filed November 8, 1937

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Ninth Circuit is granted, and the case is assigned for hearing immediately following No. 406.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

U. S. GOVERNMENT PRINTING OFFICE: 1937

INDEX

	Page
Opinions below	1
Jurisdiction	2
Question presented	2
Statute involved	3
Statement	4
Specification of errors to be urged	7
Reasons for granting the writ	7
Conclusion	11

CITATIONS

Cases:	
Commissioner v. *Fleming*, 82 F. (2d) 324	7, 11
Helvering v. *Bankline Oil Co.*, No. 387, present term	10
Helvering v. *O'Donnell*, No. 406, present term	10
Helvering v. *Twin Bell Syndicate*, 293 U. S. 312	9
Palmer v. *Bender*, 287 U. S. 551	9
Thomas v. *Perkins*, decided June 1, 1937, No. 824, 1936 term	9, 10
Statute:	
Revenue Act of 1928, c. 852, 45 Stat. 791:	
Sec. 23	3
Sec. 114	4

In the Supreme Court of the United States

OCTOBER TERM, 1937

No. —

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ELBE OIL LAND DEVELOPMENT COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

The Solicitor General, on behalf of Guy T. Helvering, Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Ninth Circuit, entered in the above cause on June 21, 1937, reversing a decision of the Board of Tax Appeals.

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 69–76) is reported in 34 B. T. A. 333. The opinion of the Circuit Court of Appeals has not yet been officially reported.

16808—37

JURISDICTION

The judgment of the Circuit Court of Appeals was entered June 21, 1937. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

In 1927 the taxpayer sold, assigned, transferred and conveyed all its right, title and interest in and to certain oil and gas leases, drilling equipment, etc., in consideration of a cash payment of $350,000 and thereafter, if the purchaser did not elect to abandon the purchase, the sum of $400,000 on the 14th day of March of each of the years 1928, 1929 and 1930, and $450,000 on March 14, 1931, or a total of $2,000,000. The agreement provided that from and after the time when the purchaser shall have been reimbursed, from the sale of oil and gas from the properties, for all expenditures made in the acquisition, development and operation of the properties, the purchaser should pay to the taxpayer 33⅓ per cent of its net profits, as therein defined, from the operation of the properties.

The question is whether, under Section 114 (b) of the Revenue Act of 1928, the taxpayer is entitled to a depletion deduction of 27½ per cent of the cash instalment payments received in each of the years 1928 and 1929.

STATUTE INVOLVED

The Revenue Act of 1928, c. 852, 45 Stat. 791, provides in part as follows:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> * * * * *
>
> (l) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In the case of leases the deduction shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each. * * *
>
> * * * * *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * *

(b) *Basis for depletion.*—

* * * * *

(3) *Percentage Depletion For Oil And Gas Wells.*—In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

STATEMENT

As of October 3, 1927, under the terms of a written agreement (R. 37–64), the taxpayer sold, assigned, transferred and conveyed all its right, title and interest in and to certain described prospecting permits, drilling agreements, leases, and equipment unto the Honolulu Consolidated Oil Company (hereinafter referred to as Honolulu), the latter to "have the sole ownership of and the right to sell or otherwise dispose of, all oil and/or gas and derivative products produced in, on or upon said properties", it being "the intention of the parties to this agreement that the full and complete ownership, control and operation of said properties shall vest, upon execution hereof, in Honolulu * * *

and Elbe [the taxpayer] shall have no interest in or to any of said properties whatsoever." (R. 44–45.) The consideration to be paid the taxpayer, as set forth in paragraph 7 of the agreement, was $350,000 cash upon execution of the agreement, and thereafter, if Honolulu did not elect to abandon the purchase of the properties and execute reconveyances as provided by paragraph 9 of the contract, the sum of $400,000 on the 14th day of March of each of the years 1928, 1929 and 1930, and $450,000 on March 14, 1931, together with interest as specified. (R. 34, 47–48, 71.) Of such $2,000,000 to be received by the taxpayer, the amount of $1,963,672.95 was consideration for the oil and gas rights in the leases and the remainder was consideration for equipment and other property conveyed. (R. 35, 71.) The consideration of $2,000,000 for such sale was to be paid without reference to, and without being in any manner based upon, the production of oil from the properties conveyed. (R. 71.)

The contract, in paragraph 8 thereof (R. 48–54), provided that, "from and after the time" when Honolulu should have been reimbursed, from its sales of oil and gas from the properties, for all expenditures made in the acquisition, development and operation thereof, it should pay to the taxpayer 33⅓ per cent of its net profits, as defined in the contract, resulting from the production and operation of the properties (R. 48, 72). Up to the date of the hearing before the Board, no payments

became due or were made to the taxpayer by Honolulu under the terms of paragraph 8. (R. 35, 72.)

The agreement, in paragraph 12 thereof, provided that, anything contained in the agreement to the contrary notwithstanding, it was the intention of the parties that the full ownership, possession and control of all the properties should vest in Honolulu. (R. 61.)

The taxpayer has received each of the payments, in the amounts and on the dates specified in the agreement, totaling $2,000,000. The cost of all the properties transferred under the agreement was less than the amount of $350,000 received in 1927, and for that year the taxpayer reported a taxable gain from the transaction by applying the entire cost basis against the payment received in that year. (R. 71.)

In filing its income tax returns for the years 1928 and 1929, the taxpayer reported as income the $400,000 payment received in each of those years, and claimed as a deduction 27½ per cent thereof as an allowance for depletion. (R. 35–36, 71–72.) The Commissioner of Internal Revenue determined that the taxpayer was not entitled to any deduction for depletion (R. 36), and his action was affirmed by the Board of Tax Appeals (R. 69–77). Upon appeal, the Circuit Court of Appeals reversed, holding that percentage depletion was allowable on the payments received in 1928 and 1929.

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that the taxpayer was entitled to a 27½ per cent depletion allowance on the cash payments it received in each of the years 1928 and 1929.

2. In holding that the taxpayer retained such an interest in the oil and gas in place as entitled it to depletion allowances on the cash payments received in each of the years 1928 and 1929.

3. In holding that the taxpayer is entitled to depletion allowances for the years involved.

4. In reversing the Board of Tax Appeals.

REASONS FOR GRANTING THE WRIT

1. The decision of the Circuit Court of Appeals, holding that the taxpayer is entitled to deduct percentage depletion on the cash payments received in 1928 and 1929, is in direct conflict with the decision of the Circuit Court of Appeals for the Fifth Circuit in *Commissioner* v. *Fleming,* 82 F. (2d) 324. There, the taxpayer was the owner of an undivided interest in two oil and gas leases on which the landowner had reserved a one-eighth royalty. In 1928, by written instrument the taxpayer and the other owners of one of the leases sold it for $1,000,000 in cash, and $1,000,000 out of one-fourth of all oil, gas and other minerals produced. In 1929, he sold his interest in a similar gas and oil lease, together with certain equipment, part of the price to be paid by check, and the further sum of $225,000

to be paid out of the one-half of seven-eighths of the first oil produced and saved. Large amounts were received by the taxpayer in each year, both out of the cash payments and from oil produced. He contended that he was entitled to a depletion deduction on both the cash payment and the payment resulting from the production of oil. The court held, however, that the cash payment, which was not dependent upon the production of oil, was not subject to a depletion allowance. In so holding, the court said in part (pp. 327, 328):

> The making of the sale depleted nothing. The money paid did not come actually or in anyone's contemplation from the production of oil, but was the purchaser's independent capital invested by him in the oil lease. * * * We believe that the Board has correctly held that in such sales of interests in oil leases a money payment unconnected with production of oil is to be dealt with as representing a conversion of capital by sale, but that "oil payments" where no personal obligation is assumed by the purchaser are to have the benefit of the statutory depletion allowance.

So it is in this case. The making of the sale depleted nothing. The cash payments aggregating $2,000,000 were to be made without reference to, and without being in any manner based upon, the production of oil from the properties. It is true that until March 14, 1929, Honolulu had a right to abandon the purchase of the properties, but this

election did not depend upon whether oil and gas were being produced. The election was within the sole discretion of Honolulu, and might turn on any of the factors which influence a purchaser, e. g., the fluctuations in the selling price of oil, etc.

2. The Circuit Court of Appeals improperly extended and misapplied the decision in *Palmer* v. *Bender,* 287 U. S. 551, by holding that the taxpayer had at all times an economic interest in the oil produced (from which premise it concluded that depletion allowances on the cash payments were proper). In the *Palmer* case, this Court held that the language of the statute was broad enough to allow a deduction for depletion in every case in which the taxpayer had retained an economic interest in the oil and gas in place.

Here, the taxpayer did not retain an economic interest in the oil and gas in place, but only the right, after certain contingencies had happened, to share in the *net profits* accruing to Honolulu from the operation of the properties. It retained neither the right to share in the oil produced and saved, as in *Palmer* v. *Bender, supra,* nor the right to receive royalties, in cash or in kind, equal to a specified proportion of the oil extracted, as in *Helvering* v. *Twin Bell Syndicate,* 293 U. S. 312, 315, 321, nor a right to receive a specified amount out of the gross proceeds of the oil, as in *Thomas* v. *Perkins,* decided June 1, 1937, No. 824, October Term, 1936. Its only interest was a right under the agreement to

receive a specified portion of Honolulu's net profits, if any, from operation of the leases. Such an interest cannot be said to constitute that *ownership,* either of the oil produced or of its precise equivalent, the gross proceeds of the oil, which under the statute is essential.

In *Thomas* v. *Perkins, supra,* this Court, in discussing the *Palmer* case, said:

> Thus in that case we held assignors' mere stipulation for royalty out of oil operated to save to them an economic interest in the *oil* sufficient to entitle them to deduct from their income derived from the oil an allowance for depletion. If Palmer had retained no interest in the oil he would have been entitled to no deduction on account of depletion. *Ownership was essential.* [Italics supplied.]

It follows that the taxpayer, having disposed of its interest in the oil in place, is not entitled to depletion allowances.

This question is also presented in *Helvering* v. *O'Donnell,* pending on the Commissioner's petition, No. 406, present term.

3. Petition for certiorari has heretofore been filed by the Commissioner in *Helvering* v. *Bankline Oil Co.,* No. 387, present term, involving a closely related question. Apart, however, from the pendency of the petitions in the *O'Donnell* and *Bankline* cases, it is submitted that certiorari should be

granted here in order to resolve the conflict with the decision of the Circuit Court of Appeals for the Fifth Circuit in *Commissioner* v. *Fleming*, p. 7, *supra*.

CONCLUSION

Wherefore, it is respectfully submitted that this petition should be granted.

STANLEY REED,
Solicitor General.

SEPTEMBER 1937.

U. S. GOVERNMENT PRINTING OFFICE: 1937

INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statute involved	2
Statement	4
Specification of errors to be urged	7
Summary of argument	7
Argument	9
I. The transaction was clearly a sale by Elbe to Honolulu unless its character was changed by the provisions of paragraph 8 for ultimate payment to Elbe of a share of Honolulu's net profits	11
II. Cash payments received from another who is entitled to reimbursement from production are not subject to depletion	15
III. The taxpayer did not acquire a royalty interest under the provisions entitling it to receive a share of the purchaser's net profits after the purchaser had been reimbursed for all expenditures	23
Conclusion	26

CITATIONS

Cases:

Burnet v. *Harmel*, 287 U. S. 103 ..... 14, 19
Commissioner v. *Fleming*, 82 F. (2d) 324 22
Darby-Lynde Co. v. *Alexander*, 51 F. (2d) 56, certiorari denied, 284 U. S. 666 12
Helvering v. *Twin Bell Oil Syndicate*, 293 U. S. 312 10
Herring v. *Commissioner*, 293 U. S. 322 ..... 15, 19
Murphy Oil Co. v. *Burnet*, 287 U. S. 299 ..... 14, 15
Palmer v. *Bender*, 287 U. S. 551 10
Reinecke v. *Spalding*, 280 U. S. 227 14
Thomas v. *Perkins*, 301 U. S. 655 ..... 8, 10, 13

Statute:

Revenue Act of 1928, c. 852, 45 Stat. 791:
Sec. 23 2
Sec. 114 3

Miscellaneous:

Treasury Regulations No. 77 (1932), Art. 221 (g) 20

37213—38——1

In the Supreme Court of the United States

OCTOBER TERM, 1937

No. 446

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ELBE OIL LAND DEVELOPMENT COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 69–76) is reported in 34 B. T. A. 333. The opinion of the Circuit Court of Appeals (R. 86–91) is reported in 91 F. (2d) 127.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered June 21, 1937 (R. 91). The petition for a writ of certiorari was filed September 21, 1937, and granted November 8, 1937 (R. 92). The jurisdiction of this Court is conferred by Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

In 1927 the taxpayer sold all its interest in certain oil and gas leases, including equipment, in consideration of a cash payment of $350,000, and of further payments of $400,000 on the fourteenth day of March of each of the years 1928, 1929, and 1930, and of $450,000 on March 14, 1931, or a total of $2,000,000. The agreement provided that the purchaser might elect to abandon the purchase before making either the 1928 or 1929 payments. It further provided that from and after the time when the purchaser should have been reimbursed, from the sale of oil and gas from the properties, for all expenditures made in the acquisition, development, and operation of the properties, the purchaser should pay to the taxpayer one-third of its net profits, as therein defined, from the operation of the properties.

The question is whether, under Section 114 (b) of the Revenue Act of 1928, *infra*, the taxpayer is entitled to a depletion deduction of 27½ per cent of the cash installment payments received in each of the years 1928 and 1929.

STATUTE INVOLVED

The Revenue Act of 1928, c. 852, 45 Stat. 791, provides in part as follows:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> * * * * *

(1) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In the case of leases the deduction shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each.

* * *

* * * * *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * *

(b) Basis for depletion.—

* * * * *

(3) PERCENTAGE DEPLETION FOR OIL AND GAS WELLS.—In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the prop-

> erty during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

STATEMENT

Respondent, a California Corporation, was organized on February 4, 1925. It acquired certain properties consisting of oil and gas prospecting permits, drilling agreements, leases, and equipment. Development work carried on by it resulted in the discovery of oil, and on October 3, 1927, oil was being produced in commercial quantities. (R. 34, 70.)

As of October 3, 1927, under the terms of a written agreement (R. 37–64), the taxpayer sold, assigned, transferred, and conveyed all its right, title, and interest in and to certain described prospecting permits, drilling agreements, leases, and equipment to the Honolulu Consolidated Oil Company (hereinafter referred to as Honolulu), the latter to "have the sole ownership of and the right to sell or otherwise dispose of, all oil and/or gas and derivative products produced in, on or upon said properties," it being "the intention of the parties to this agreement that the full and complete ownership, control and operation of said properties shall vest, upon execution hereof, in HONOLULU * * * and ELBE [the taxpayer] shall have no interest in or

to any of said properties whatsoever." (R. 45.)

The consideration to be paid the taxpayer, as set forth in paragraph 7 of the agreement, was $350,000 in cash upon execution of the agreement, and thereafter, if Honolulu did not elect to abandon the purchase before making either of the two succeeding payments, as provided by paragraph 9 of the contract, the sum of $400,000 on the fourteenth day of March of each of the years 1928, 1929, and 1930, and $450,000 on March 14, 1931, together with interest as specified (R. 34, 47–48, 71). Of such $2,000,000 to be received by the taxpayer, the amount of $1,963,672.95 was consideration for the oil and gas rights in the leases and the remainder was consideration for equipment and other property conveyed (R. 35, 71). The consideration of $2,000,000 was to be paid without reference to, and without being in any manner based upon, the production of oil from the properties (R. 71).

The agreement, in paragraph 8 thereof (R. 48–54), provided that "from and after the time" when Honolulu should have been reimbursed from its sales of oil and gas from the properties for all expenditures made in the acquisition, development, and operation thereof, it should pay to the taxpayer 33⅓ per cent of its net profits, as therein defined, resulting from the production and operation of the properties (R. 48, 72). Up to the date of the hearing before the Board, no payments became due or were made to the taxpayer by Honolulu under the terms of paragraph 8 (R. 35, 72).

The agreement, in Paragraph 12 thereof, provided that, anything contained therein to the contrary notwithstanding, it was the intention of the parties that the full ownership, possession, and control of all the properties should vest in Honolulu and that Elbe should have no interest whatsoever in the properties (R. 61).

The taxpayer has received each of the payments in the amounts and on the dates specified, totaling $2,000,000. The cost to the taxpayer of all the assets transferred under the agreement was less than the amount of $350,000 received in 1927. In its return for that year the taxpayer treated the transaction as a sale and reported as taxable income the difference between the cost basis of the property and the payment received in that year (R. 35, 71).

In filing its income tax returns for the years 1928 and 1929, the taxpayer reported as income the $400,000 payment received in each of those years, and claimed as a deduction 27½ per cent thereof as an allowance for depletion (R. 35–36, 71–72). The Commissioner of Internal Revenue determined that the taxpayer was not entitled to any deduction for depletion (R. 36), and his action was affirmed by the Board of Tax Appeals (R. 69–77). Upon appeal the Circuit Court of Appeals reversed the decision of the Board, holding that percentage depletion was allowable on the cash installment payments received in each of the years 1928 and 1929. One judge dissented (R. 90).

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that the taxpayer was entitled to a 27½ per cent depletion allowance on the cash payments it received in each of the years 1928 and 1929.

2. In holding that the taxpayer retained such an interest in the oil and gas in place as entitled it to depletion allowances on the cash payments received in each of the years 1928 and 1929.

3. In holding that the taxpayer is entitled to depletion allowances for the years involved.

4. In reversing the Board of Tax Appeals.

SUMMARY OF ARGUMENT

I. Apart from the provisions of the agreement whereby Honolulu undertook to pay the taxpayer one-third of its net profits after reimbursement for all expenditures, the respondent beyond question would have no basis for a claim to depletion upon the cash payments. The payments were not made out of production, nor are they to be regarded as dependent upon production merely because the taxpayer might have abandoned the purchase before making them. The payments were expressed to be the consideration for a sale; and the taxpayer itself in a previous return so treated an earlier payment. The effect upon the character of the payments of the respondent's contingent right to share in future net profits ought not to be considered in the absence

of any showing of a reasonable expectation that such right will become operative.

II. Even if the payments to which respondent is contingently entitled in the future be regarded as royalties subject to depletion when made, the present cash payments cannot properly be treated as a bonus or advance royalties. The decisive circumstance setting this case apart from the cases of a bonus heretofore decided by this Court is that Honolulu, having paid $2,000,000 to Elbe, is entitled to reimburse itself for this and all other expenditures before any further payments are made. With respect to the oil to which Honolulu looked for reimbursement the transaction was in substance a sale. The payments were not advance royalties for the right of extracting oil and gas which would be allocable, in computing Honolulu's depletion allowance, to production throughout the life of the well. They were advance payments for oil of a determinate and presumably equivalent amount allocated by the parties themselves to the first oil to be produced and saved. With respect to all oil produced until reimbursement is complete, Honolulu is solely entitled to the depletion allowance. It owns the oil and receives the "gross income from the property." Its position is indistinguishable from that of assignors who have retained the right to receive oil up to a designated amount and who have been held to be entitled to depletion. *Thomas* v. *Perkins,* 301 U. S. 655. The circumstance that current production dimin-

ishes the source available for future payments to respondent is irrelevant. Honolulu is in the same position.

III. A right to a specified proportion of the net profits of an operator of an oil or gas well does not give rise to a depletable interest in the oil in place since the holder thereof does not own the oil produced and does not receive "gross income from the property." The impossibility of regarding the contingent payments provided for in the present case as "gross income from the property" is emphasized by the elaborate mechanism set up for their computation. Since the respondent would not be entitled to depletion upon the payments of a share of Honolulu's net profits, if made, the existence of a contingent right to such payments cannot alter the character of the cash payments here in question.

ARGUMENT

The theory of Congress in permitting a deduction for depletion is that it will compensate the owner of a wasting asset for the exhaustion sustained in the production of taxable income. A capital interest in the mineral in place is, therefore, a prerequisite of the right to a depletion allowance. This interest, however, need not consist of any form of legal ownership of the mineral content of the land. What is essential is that the taxpayer be entitled to a share of the mineral produced, or

of its gross proceeds. *Palmer* v. *Bender,* 287 U. S. 551; *Helvering* v. *Twin Bell Oil Syndicate,* 293 U. S. 312. "If so he has an economic interest in the oil, in place, which is depleted by production." *Palmer* v. *Bender,* 287 U. S. at 557.

The depletion allowance is a percentage of "gross income from the property," which means gross income from oil and gas. *Helvering* v. *Twin Bell Oil Syndicate, supra.* The decisions of this Court have uniformly confined the right to participate in the allowance to persons entitled to payments out of oil or the gross proceeds of oil, and have permitted the deduction only from such payments themselves or from cash payments which could be regarded as advance royalties paid in anticipation of the extraction of oil. They uniformly recognize that the right thus to share in the oil as it comes from the well is indispensable to ownership of a depletable interest in the oil in place.

In *Thomas* v. *Perkins,* 301 U. S. 655, 661, this Court in discussing the *Palmer* case said:

> Thus in that case we held assignors' mere stipulation for royalty out of oil operated to save them an economic interest in the oil sufficient to entitle them to deduct from their income derived from the oil an allowance for depletion. If Palmer had retained no interest in the oil he would have been entitled to no deduction on account of depletion. Ownership was essential.

If, as this Court thus stated, ownership of the oil is essential, the decision under review cannot be supported.

I

THE TRANSACTION WAS CLEARLY A SALE BY ELBE TO HONOLULU UNLESS ITS CHARACTER WAS CHANGED BY THE PROVISIONS OF PARAGRAPH 8 FOR ULTIMATE PAYMENT TO ELBE OF A SHARE OF HONOLULU'S NET PROFITS

Apart from the provisions of paragraph 8 whereby Honolulu undertook to pay Elbe one-third of its net profits after reimbursement for expenditures, the taxpayer beyond question would have no basis for a claim to depletion upon the present payments. The case in this aspect differs sharply from *Thomas* v. *Perkins, supra.* There oil leases were assigned in terms of outright sale in consideration of an agreement to pay $395,000 in periodic payments which were to be one-fourth of all the oil produced and saved, and which were to be due only if, as, and when oil was produced. Thus, in that case the making of the payments and the amount of each payment (until the total was paid) were wholly dependent upon production. The payments were to be made out of production. Upon the ground that a certain proportion of oil had thus been withheld from the grant, the assignors were declared to be entitled to depletion. In the instant case payments of a prescribed amount were to be

made, as the Board found (R. 71), without reference to the production of oil or gas from the properties; and there is no basis for suggesting that any oil was withheld from the grant. The two payments here involved clearly do not constitute income from production merely because Honolulu had the right, before making either of them, to abandon the purchase of the properties. The most that can be said is that Honolulu made the payments expecting ultimately to be reimbursed from production.[1] There is a similar expectation in the case of any sale, be it subject to an option or absolute.

The agreement between Honolulu and the taxpayer specifically provided that it was the intention of the parties that full and complete ownership of the properties should vest in Honolulu and the taxpayer should "have no interest in or to any of said properties whatsoever" (R. 45). Such sweeping language could find no proper place in any instrument but that of a contract of sale. It is clear that payments made pursuant to a sale, which are not derived from production, are not subject to depletion. *Darby-Lynde Co.* v. *Alexander,* 51 F. (2d) 56 (C. C. A. 10th), certiorari denied, 284 U. S. 666.

---

[1] Thus, Honolulu might well have acquired the property as a reserve though no production whatever had occurred, or it might have elected to abandon the purchase, in view of market conditions or development of other properties, even though production was actually taking place.

That the transaction was a sale and not a sublease is further shown by the fact that the taxpayer treated it as a sale in its income tax return for 1927, the year the transaction was consummated. For that year it reported a profit of $83,444.58 from the transaction by deduction from the cash payment of $350,000 of the entire cost basis of the properties so transferred. Thus, the taxpayer has already received a return of its capital investment. This being so, it seems clear that it is not entitled to further deductions under the guise of depletion allowances.

If the transaction was not a sale, it must be because the terms of absolute conveyance in the instrument are to be treated not merely as "qualified" (*Thomas* v. *Perkins,* 301 U. S. at 659) but as nullified by the contingent rights elsewhere conferred upon Elbe ultimately to share in Honolulu's net profits. The record is barren of evidence to show that any reasonable expectation exists that payments ultimately will be made under paragraph 8. The Commissioner ruled that (R. 15, 16)—

> The consideration of $2,000,000.00 is definite as to amount and periods of payment and it was the entire known consideration when the contract was executed. The possibility of the taxpayer sharing in the net profits from the operation of the properties conveyed was contingent upon profits being earned great enough to extinguish the full

costs of acquisition and development.
* * *

The Board of Tax Appeals held that the nature of the cash payments made by Honolulu was unaffected by its "wholly contingent obligation for future payments under its contract of purchase" (R. 72). The burden is upon the taxpayer to establish its right to the depletion allowance. Compare *Reinecke* v. *Spalding*, 280 U. S. 227, 232; *Murphy Oil Co.* v. *Burnet*, 287 U. S. 299, 308. In these circumstances we think that in the absence of a showing that paragraph 8 was something more than a paper provision, the holding of the Board that the payments in question constituted proceeds from the sale of a capital asset should have been affirmed.

Treating the question of the respondent's rights under paragraph 8 as open, and conceiving that the provision vested in the respondent a royalty interest,[2] entitling it to depletion upon any payments made thereunder, the court below held that the cash payments here in question were "in effect a guarantee of future oil production and made because of such anticipated production" (R. 90), and constituted, therefore, advance royalties likewise subject to depletion.[3] Compare *Burnet* v. *Harmel*, 287

[2] By inadvertence the court mistakenly described this interest of the respondent (R. 87) as a right "to receive one-third of all oil produced."

[3] Judge Haney concurred "solely on the ground that although *Palmer* v. *Bender*, 287 U. S. 551 is distinguishable on its facts, the language used therein is general enough to embrace the facts herein." Judge Garrecht dissented (R. 90).

U. S. 103; *Murphy Oil Co.* v. *Burnet*, 287 U. S. 299; *Herring* v. *Commissioner*, 293 U. S. 322.

In so holding, we think the court below was doubly in error. The respondent did not acquire a royalty interest by virtue of its contingent rights under the contract to share in Honolulu's net profits from the operation of the leases. Nor, if it had, would it follow that the present cash payments are to be treated as depletable advance royalties. The latter point, being the short answer to the taxpayer's principal contention, may appropriately be discussed first.

II

CASH PAYMENTS RECEIVED FROM ANOTHER WHO IS ENTITLED TO REIMBURSEMENT FROM PRODUCTION ARE NOT SUBJECT TO DEPLETION

The respondent urges that the making of the payments here in question reduced the quantity of oil available as a source of future payments under paragraph 8, since Honolulu was entitled to be reimbursed for them out of production before the later payments were made. "Thus in effect", it is said (brief in opposition to petition for certiorari, p. 7), "each payment here was but advance or minimum royalty."

Depletion which is allowed to Elbe evidently must be denied to Honolulu. Percentage depletion cannot be claimed upon an aggregate basis in excess of 100 percent of the gross income from the property. *Helvering* v. *Twin Bell Oil Syndicate,*

supra. Before the provisions of paragraph 8 become operative, $2,000,000 worth of oil must be extracted from the property—plus an amount sufficient to reimburse Honolulu for all other expenditures as defined in the agreement. Honolulu concededly will be entitled to percentage depletion upon this excess over $2,000,000. With respect to the $2,000,000 worth of oil, however, the allowance if given to Elbe upon the so-called advance payments must be denied to Honolulu when actual production of the oil takes place.

The insufficiency of the argument advanced in support of Elbe's claim to depletion to the exclusion of Honolulu must be apparent, for it is one which could equally well be made by Honolulu in support of a claim to depletion to the exclusion of Elbe. Honolulu, like Elbe, has a right to share in the net profits under paragraph 8 of the agreement. Extraction of oil in advance of the time when that paragraph becomes operative diminishes the value of Honolulu's right no less than that of Elbe's. If an interest in *future* production (assuming that Elbe has such an interest) suffices as a basis for depletion with respect to current production, both parties in the present situation would be equally entitled to the allowance.

The respondent's contention, we submit, rests upon a fundamental misapprehension. Depletion represents capital *extracted* from the property, not capital which is still in the ground. The right to depletion with respect to oil produced during any

particular period must therefore depend primarily upon ownership of *that oil,* not upon ownership of the oil in the ground. The interests of the parties in future production, under paragraph 8, is thus irrelevant. The decisive consideration is the interest of the parties with respect to the $2,000,000 worth of oil to be produced prior to that time. With respect to that oil, the respondent clearly has no longer a capital interest. It has been paid in full. It is Honolulu which must look to the oil produced before paragraph 8 comes into operation for a return of its capital. Until that time, the entire "gross income from the property" is Honolulu's. Under the statute Honolulu is therefore entitled to depletion. For the present, Honolulu has that ownership of oil *as produced* which this Court, in *Thomas* v. *Perkins, supra,* said was essential. Indeed, if there is not enough oil in the well to permit either party to enjoy "net profits" under paragraph 8, Honolulu—economically as well as legally—owns not only the oil currently produced but *all* the oil in place.

The decision of this Court in *Thomas* v. *Perkins, supra,* we think is controlling of the case at bar. There Hammonds and Bronson assigned to Perkins all their interest in certain oil leases in consideration of the right to receive one-fourth of all oil produced and saved up to the aggregate amount of $395,000. The Court held that the transaction amounted to a retention by the assignors of sufficient oil to produce such an amount, and that the

assignors were entitled to depletion upon the oil so produced. This decision was reached without regard to the circumstance that Perkins as owner of the residuary interest in the well was the party primarily affected by extraction of the oil necessary to make up the stipulated payments. Ownership of the *oil produced,* the Court held, was controlling with respect to the right to deduct percentage depletion from the gross income from that oil. The only possible distinction between the case at bar and that case is that Honolulu has *acquired* instead of *retained* the right to receive sufficient oil to produce a designated amount. The difference between a grant and a reservation from a grant assuredly is without importance here. In all material respects the two cases are indistinguishable. Like Perkins' assignors, Honolulu undoubtedly owns the oil as produced. Like them it receives the "gross income from the property." Perkins' assignors bore the risk that sufficient oil would be in the well to complete the payments. It was they who were looking to the oil paid over to them for a return of capital. Honolulu similarly bears the risk that sufficient oil will be in the well to reimburse it. Honolulu similarly is looking to the oil produced—until the reimbursement is complete for a return of its capital. Unlike Perkins' assignors, moreover, Honolulu is entitled to the *whole* of production until such reimbursement has taken place, and unlike them also it has a residuary interest in the oil thereafter in the well.

The payments in question, it seems apparent, are not advance royalties. A royalty is a payment in the nature of rent for the right of extracting oil and gas from the property. It is a share of production given by the operator of the well in return for the right to reduce the remaining share to ownership. A bonus paid upon the signing of an oil lease is regarded as an advance royalty, and held to be depletable, upon the theory that it represents an additional share of production given for the right of extracting oil from the property and is, therefore, of essentially the same character as the royalty itself. "The payment of an initial bonus alters the character of the transaction no more than an unusually large rental for the first year alters the character of any other lease * * *." *Burnet* v. *Harmel, supra,* 287 U. S. at 106. It is settled that the depletion allowance is to be apportioned between the parties interested in production according to their interest. *Helvering* v. *Twin Bell Oil Syndicate, supra.* To deny depletion to the lessor upon the bonus payment, this Court has considered, would be to apportion the allowance between the parties in disregard of their actual interest. Compare *Herring* v. *Commissioner, supra,* 293 U. S. at 327.

The present payments are not under any view payments of a share of production made in return for the right of operating the well and retaining the balance. They are payments made in return for the right of retaining oil of a determinate

amount. They are not, therefore, advance *royalties* for the right of extracting oil and gas. They are advance *payments* for oil and gas of a presumably equivalent amount—namely, the amount necessary to reimburse Honolulu for all its expenditures in connection with the property. *Pro tanto* the transaction constitutes a purchase of an economic and legal interest in the oil in place—and this regardless of the nature of the parties' relationship once Honolulu has reimbursed itself and the provisions of paragraph 8 become operative.

The decisive circumstance setting this case apart from the cases of a bonus heretofore decided by this Court is that Honolulu, having paid $2,000,000 to Elbe, is entitled to reimburse itself for this and all other expenditures before any further payments to Elbe are to be made. With respect to the first $2,000,000 worth of oil extracted from the property, therefore, the question is not one of apportionment of the depletion allowance as between lessor and lessee. The question is one of giving the deduction in full to the one party or to the other. As between Honolulu and Elbe, it seems clear that Honolulu has the depletable interest.

A true bonus—under the prevailing and plainly correct practice of the Bureau of Internal Revenue—is spread over the entire expected production of the well in computing the depletion allowance of the operator.[4] The allocation is accomplished by

[4] See Treasury Regulations No. 77 (1932), Art. 221 (g): "Where royalties in the form of bonus pay-

deducting from the actual gross proceeds of the operator in the year of production—in order to arrive at the operator's "gross income from the property"—an amount per barrel equal to the total estimated number of barrels in the well divided by the amount of the bonus.[5] Such a procedure would be obviously inappropriate in the present case. The sums here in question were not paid for the right of extracting oil or gas throughout the life of the well. They are not therefore allocable to the entire expected production. They are amounts paid for the right of retaining a determinate amount of oil. The terms of the agreement forbid their being spread throughout the life of the well. They are not royalties, therefore, but advance payments allocated by the parties themselves to the first oil to be produced and saved.

---

ments or advanced royalties (see article 230) have been paid in respect of the property in the taxable year or in prior years, the amount excluded from "gross income from the property" for the taxable year on account of such payments shall be an amount equal to that part of such payments which is allocable to the products sold during the taxable year." This provision was adopted following the decision of this Court in *Herring* v. *Commissioner*, *supra*.

[5] To illustrate: A well containing an estimated 400,000 barrels of oil is leased—the lessor receiving $100,000 in cash and a one-eighth royalty. Upon the 350,000 barrels which the lessee will obtain, he has thus paid an advance royalty of $.35 a barrel. If the lessee's share of the first year's production is 10,000 barrels, the sum of $3,500 will be deducted from the gross proceeds thereof as representing advance royalties. The lessee's deduction for depletion will be 27½ per cent of the remainder.

The decision of the court below is in substantial conflict with that of the Circuit Court of Appeals for the Fifth Circuit in *Commissioner* v. *Fleming*, 82 F. (2d) 324. There the taxpayer and other leasehold owners in 1929 had sold a lease for $175,000 in cash and the further sum of $225,000 to be paid out of one-half of seven-eighths of the first oil produced and saved. During that year the taxpayer received $43,750 as his share of the cash payment and also $9,578.17 from oil runs. In harmony with the subsequent decision of this Court in *Thomas* v. *Perkins, supra,* the court held that the receipts from oil runs were subject to depletion. As to the cash payment which was not dependent upon production, it held the contrary. As in this case, the payment evidently was not a bonus paid for the privilege of extracting oil. It was the consideration for the purchase of all the oil save that reserved by the grantors. The transaction differs from the present case only in that the taxpayer, instead of selling oil of a determinate amount, sold all the oil except a determinate amount. In neither case did the taxpayer retain any interest in the oil with respect to which the deduction for depletion was claimed.

We submit that with respect to the oil to which Honolulu looked for reimbursement the transaction was in substance a sale. The concept of a bonus as an advance royalty cannot be extended to include sums paid for the right to extract an equivalent amount of oil from the ground.

III

THE TAXPAYER DID NOT ACQUIRE A ROYALTY INTEREST UNDER THE PROVISIONS ENTITLING IT TO RECEIVE A SHARE OF THE PURCHASER'S NET PROFITS AFTER THE PURCHASER HAD BEEN REIMBURSED FOR ALL EXPENDITURES

In the view of the case which has been taken, the nature of the interest acquired by Elbe under the provisions of paragraph 8 is of no consequence. For the reasons stated in the brief for the United States in No. 406 (pp. 7–11), however, we think it clear that Elbe would not be entitled to percentage depletion upon any payments which may be made under that provision. A right to a specified proportion of the net profits of an operator of an oil or gas well does not give rise to a depletable interest in the oil in place since the holder of such a right does not own the oil as produced and does not receive "gross income from the property." *Palmer* v. *Bender, Helvering* v. *Twin Bell Oil Syndicate, Thomas* v. *Perkins,* all *supra.*

The impossibility of regarding the payments provided for in paragraph 8 as "gross income from the property" is emphasized by the elaborate mechanism set up for their computation. Reimbursement of Honolulu is to be computed by deducting from the market value at the well of gas and oil produced and saved 7½ per cent as to certain leases and 5 per cent as to others (R. 48, 49). A similar deduction is to be made in computing net profits (R. 52). Moreover, Elbe agrees to pay to

Honolulu out of its share of the first of the net profits, if any, interest at the rate of 2½ per cent per annum upon all expenditures made or incurred by Honolulu in the development and operation of the property, including the cost of acquisition from Elbe. It is apparent, we think, that Elbe is in no sense entitled to receive even net income *from production.* Rather is it a contingent promisee upon a personal covenant to pay indeterminate sums of money to be computed according to a special formula.

Since the respondent would not be entitled to depletion upon the sums ultimately payable under paragraph 8, the existence of a right to such payments under the contract cannot affect the character of the cash payments actually received. The decisions permitting deductions for depletion from bonus payments are confined to situations in which the taxpayer has indubitably acquired a depletable interest by virtue of a right to royalty payments out of oil or the proceeds of oil. Only because of that interest can the lump sum payments be regarded, in any view, as advance royalties in anticipation of the extraction of oil.

The respondent suggests (brief in opposition to petition for certiorari, pp. 8–10) that payments of net profits to one in its position must be treated as "gross income from the property" in view of the further provision of the statute that the allowance for depletion "shall not exceed 50 per centum of the net income of the taxpayer (com-

puted without allowance for depletion) from the property." The argument is that the net income of Honolulu from the property, within the meaning of the limitation, would exclude the share of net profits payable to Elbe; and that the effect of including that share in Honolulu's gross income would therefore be to cut it out "without any accounting at all." No argument or authority is offered to show that the amounts payable to Elbe would not be included within Honolulu's net taxable income. In any case, "net income * * * from the property" is not necessarily synonymous with net taxable income. We think it clear that the amounts payable to Elbe, since they are not, as regards Elbe, income "from the property" would be includable within Honolulu's "net income * * * from the property" for the purposes of the limitation; and that such amounts accordingly would receive their full accounting in computing Honolulu's depletion allowance. But were this not so, the respondent's contention would still be unpersuasive. The asserted exclusion of the amounts in question from "an accounting" would not be invariable, but would depend upon the amount of the operating expense and the size of the share of net profits payable in the particular case. Percentage depletion is merely a "statutory rule of thumb" (brief in opposition, p. 11). The operation of such a rule, on occasion, with apparent arbitrariness is no ground for rejecting a meaning which otherwise is plain.

CONCLUSION

For the reasons stated it is respectfully submitted that the judgment of the Circuit Court of Appeals is erroneous and should be reversed.

STANLEY REED,
Solicitor General.
JAMES W. MORRIS,
Assistant Attorney General.
GOLDEN W. BELL,
Assistant Solicitor General.
SEWALL KEY,
ELLIS N. SLACK,
Special Assistants to the Attorney General.
HENRY M. HART, JR.,
Attorney.

JANUARY 1938.

U. S. GOVERNMENT PRINTING OFFICE: 1938

FILED
OCT 20 1937
CHARLES ELMORE CROPLEY
CLERK

No. 446

In the Supreme Court

OF THE

United States

October Term, 1937

GUY T. HELVERING, Commissioner of Internal Revenue,

Petitioner,

v.

ELBE OIL LAND DEVELOPMENT COMPANY,

Respondent.

On Petition for a Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit

BRIEF FOR THE RESPONDENT IN OPPOSITION

GEORGE T. ALTMAN
215 West Seventh Street
Los Angeles, California
Attorney for Respondent

Independent-Review, Law Printers, 227 So. Spring St., Los Angeles. TUcker 1377

SUBJECT INDEX

	PAGE
Opinions Below	1
Jurisdiction	1
Questions Presented	1
Statutes Involved	2
Statement	2
Argument	5
Conclusion	11
Appendix	13

CITATIONS AND AUTHORITIES

CASES

Barkhaus v. Producers' etc., 192 Cal. 200, 219 Pac. 435	6
Commissioner v. Fleming, 82 Fed. (2d) 324	5
Helvering v. Twin Bell Synd., 293 U. S. 312	7
Irvin v. Gavit, 268 U. S. 161	8
Palmer v. Bender, 287 U. S. 551	5
United States v. Hickey, 17 Wall. (84 U. S.) 9	6

STATUTES

Revenue Act of 1928, Ch. 852, 45 Stats. 791	13

In the Supreme Court
OF THE
United States

GUY T. HELVERING, Commissioner of Internal Revenue,
Petitioner,
v.
ELBE OIL LAND DEVELOPMENT COMPANY,
Respondent.

BRIEF FOR THE RESPONDENT IN OPPOSITION

Opinions Below

The opinion of the Board of Tax Appeals (R. 69-76) is reported in 34 B. T. A. 333. The opinion of the Circuit Court of Appeals (R. 86-91) is reported in 91 Fed. (2d) 127.

Jurisdiction

The judgment of the Circuit Court of Appeals was entered June 21, 1937. The jurisdiction of this Court is invoked under Section 240 (a) of the *Judicial Code*, as amended by the Act of February 13, 1925.

Question Presented

The question is whether the annual payments of $400,000 each received by the taxpayer in the years 1928

and 1929 under an agreement dated October 3, 1927, were "gross income from the property" within the meaning of that phrase as used in Section 114 (b) (3) of the *Revenue Act of 1928,* so as to entitle the taxpayer to a depletion allowance of 27½ percent thereof under the provisions of that section.

Statutes Involved

The statutes involved will be found in the Appendix, *infra,* pp. 13-14.

Statement

The statement in the petition summarizing the facts is inaccurate, incomplete, and in conflict with the record. Under the heading of "Question Presented," page 2 of the Petition, the Commissioner makes a preliminary statement of the facts, involving a transfer of properties by the taxpayer to Honolulu Consolidated Oil Company (hereinafter referred to as Honolulu) under an agreement dated October 3, 1927; but he fails to make clear that with respect to each payment here in question, that is, those in 1928 and 1929, Honolulu had the election on the date specified to either make the payment or return the properties to the taxpayer. In case it elected to return the properties to the taxpayer it retained the right to the possession of all oil wells which had been completed or were in the process of drilling until such time as it had been reimbursed for all its expenditures, including the payments already made to the taxpayer. This right of election is embodied in paragraph 9 (R. 54-59) of the agreement dated October 3, 1927.

Again, under the heading of "Statement," page 4 of the Petition, the Commissioner quotes from paragraph 3 (R. 44-45) of the agreement of October 3, 1927, but in effect misquotes that paragraph by omitting therefrom the words "Subject to the provisions of Paragraph 9." On page 6 the Commissioner repeats this omission in stating the substance of paragraph 12 (R. 61). Thus by misquotation by means of omission the Commissioner has essayed to create the erroneous impression that the contract of October 3, 1927, contained recitals of a complete transfer by the taxpayer of its ownership in the properties involved, when those very recitals, even disregarding reservations in other provisions of the contract, denied a complete transfer of ownership.

Furthermore, on page 5 of the Petition, and again on page 8, the Commissioner states that the "consideration of $2,000,000 for such sale was to be paid without reference to, and without being in any manner based upon, the production of oil from the properties conveyed." This is a mere inference entirely unsupported by the record. There was nothing in the agreement of October 3, 1927, preventing Honolulu from basing its election to make a payment or return the properties on the actual results of production of oil from the properties. That the election would necessarily be based on such actual results of production of oil is obvious from the fact that the properties transferred consisted only (R. 39-43) of *oil and gas* prospecting permits, *oil and gas* drilling agreements, *oil and gas* leases, and *oil and gas* producing equipment. The Commissioner, in an effort to avoid such a conclusion, actually concedes it. He says, on page 9 of the Petition,

"The election was within the sole discretion of Honolulu, and might turn on any of the factors which influence a purchaser, e. g., the fluctuations in the selling price of oil, etc." Of what influence would the selling price of oil be if there were no oil to sell? The record, in fact, shows that between the date of the contract, October 3, 1927, and the date of the first optional annual payment, March 14, 1928, five wells were spudded in and completed; and between the latter date and the date of the second optional annual payment, March 14, 1929, seven more wells were completed. (R. 67-68). In practical effect, therefore, the election to make a payment or return the properties, and consequently the payment itself, did depend on whether oil and gas were being produced, and this the court below pointed out in its opinion. (R. 88).

In addition, it should be observed that Honolulu bound itself to the taxpayer to perform all work and labor required under the permits and leases transferred to it and to pay the royalties required thereunder to the United States, the original permittees, and the original lessors (R. 45-47), provided, however, that it might surrender to the taxpayer the properties or any part thereof, and be thereupon released of said obligation assumed with respect to the properties surrendered. (R. 60).

Moreover, Honolulu was required to render monthly statements of operations to the taxpayer (R. 59), with right in the taxpayer to examine the books of Honolulu and to have audits made of them (R. 59), and to come upon and examine any of the properties. (R. 61). And from the very beginning Honolulu was required to pay the taxpayer, monthly, the latter's reserved one-third of

the net profits from the properties after reimbursement of Honolulu for its expenditures under the contract, including the annual payments so far made to the taxpayer. (R. 46-54).

ARGUMENT

1. The first reason given by the Commissioner for granting of the writ is an alleged conflict between the decision of the court below and the decision of the Circuit Court of Appeals for the Fifth Circuit in *Commissioner v. Fleming*, 82 F. (2d) 324. The retained interest in the *Fleming* case, however, was an interest limited in aggregate amount, while the reserved interest here was a permanent one. In distinguishing *Palmer v. Bender*, 287 U. S. 551, the Fifth Circuit Court in the *Fleming* case stated (p. 327):

> "The taxpayer asserts that the money got from the production of oil was certainly subject to depletion because he had 'an economic interest' in the oil in the ground, and that what was paid in cash stands on the same footing as a cash bonus paid to a lessor, citing especially Palmer v. Bender, supra, decided since the Pugh case and involving the transfer of a lessee's interest for cash and oil payments. In Palmer v. Bender, however, the transferor reserved an additional royalty, and so was in reality a sublessor, and the cash paid him could more readily be treated as a bonus or advance royalty."

Thus the Fifth Circuit Court in the *Fleming* case distinguished *Palmer v. Bender*, supra, on the ground that in the latter case the assignor was in effect a sublessor, having reserved a *permanent* interest in the leases trans-

ferred, while in the case before it the assignor was truly an assignor, the interest reserved being limited in aggregate amount, after payment of which the assignee's interest would continue but the assignor would have no interest left whatever. This very point by which the Fifth Circuit Court in the *Fleming* case distinguished *Palmer v. Bender* would have enabled that court to distinguish the case here and place it on all fours with *Palmer v. Bender*.

In a true assignment of a lease the assignor reserves no interest in the lease assigned. If he reserves any interest, whether it be of a portion of the term, or a portion of the premises, or some estate or interest in the premises, it is not an assignment but a sublease. *Barkhaus v. Producers' Fruit Co.*, 192 Cal. 200, 219 P. 435, 437. A transfer of a lease is a sublease, not an assignment, if the terms of the transfer are different from those of the original lease. *United States v. Hickey*, 17 Wall. (84 U. S.) 9, 13. By these tests the facts in the *Fleming* case, after the aggregate amount specified would be paid so as to leave no interest in the assignor, present, indeed, a pure assignment. By the same tests the facts here present a true sublease. The taxpayer's reserved interest here of one-third of the net profits after reimbursement of Honolulu for its expenditures was a permanent interest, just as in *Palmer v. Bender*. Thus the *Fleming* case, in the argument whereby it distinguishes *Palmer v. Bender*, in fact supports the decision here of the court below.

Not only in the reserved interest, but in the very payments as to which percentage depletion is claimed, the case here is wholly distinguishable from the *Fleming* case.

The payment in the *Fleming* case as to which percentage depletion was denied by the court, was a cash payment on the execution of the contract. Obviously that payment was not dependent on production under the contract. Here the two payments involved were not made on the execution of the contract but after possession had been transferred and production begun under the contract; and they were optional payments, dependent in necessary effect on the results of production. Obviously, too, in the *Fleming* case the cash payment itself depleted nothing. But each payment here involved reduced proportionately the amount the taxpayer would receive under its reserved interest in the net profits of production, since Honolulu was to be first reimbursed out of production for these payments before arriving at the profits one-third of which were distributable to the taxpayer. Thus in effect each payment here was but advance or minimum royalty.

The *Fleming* case, therefore, in its own argument, in the nature of the retained interest involved, and in the nature of the cash payment against which percentage depletion was denied, is entirely distinguishable from the case here.

2. The Commissioner, as a second reason for granting of the writ, says that the retained interest of the taxpayer in the net profits of production was not precisely the same kind of an interest as the retained interest involved in *Palmer v. Bender*, supra, nor as that involved in *Helvering v. Twin Bell Syndicate*, 293 U. S. 312, nor as that involved in *Thomas v. Perkins*, decided by this

court June 1, 1937. The Commissioner's syllogism, paraphrased in homely terms, is this: an oak, an elm, and a poplar are trees; a birch is neither oak, nor elm, nor poplar; therefore, a birch is not a tree. Or does the Commissioner mean to imply that the precise types of retained interests involved in the three cases cited exhaust the types of interest classifiable as an economic interest in the oil in place? Indeed, in following and discussing *Palmer v. Bender* this court in *Thomas v. Perkins* stated that ownership was essential. But in its very reference to *Palmer v. Bender* this court in the *Perkins* case showed that ownership did not mean only technical ownership, but any economic interest in the oil in place depleted by production. That an interest in the net profits is depleted by production is obvious. That an interest in the net profits is an interest in the source of the profits, here the oil in place, has never been denied by this court. The expressions of this court on the point have, in fact, been to the contrary. *Irvin v. Gavit,* 268 U. S. 161, 167-168.

The very provision of the statute, moreover, granting the allowance of percentage depletion, Section 114 (b) (3), bases a limitation on the *net* income from the property; and the application of this limitation makes the Commissioner's contention mathematically impossible. Thus, suppose the operator's gross income from the property, after deducting all rents and royalties paid or accrued (*Helvering v. Twin Bell Syndicate,* supra), except its assignor's one-third share of the net profits, is $90,000, and its operating expense, $30.000. Of the net profit shown of $60,000, the operator's share is $40,000, and the assignor's share, $20,000. According to the Commis-

sioner's contention percentage depletion allowable to the operator would be determined as follows:

1. Gross income (after deducting rents and royalties paid or accrued, *except* assignor's one-third share of net profits)	$90,000	
2. 27½ per cent thereof		$24,750
3. Operating expense	30,000	
4. Net profit	$60,000	
5. Operator's share (two-thirds)	$40,000	
6. 50 per cent thereof		$20,000
7. Percentage depletion allowable to operator (the lesser of items *2* and *6)*		$20,000

Thus in arriving from gross income to net income, with respect to the operator, the Commissioner cuts out (between items *4* and *5* above) the assignor's share of the net income, *without any accounting at all.* The only possible way to apply the statute is to deduct the assignor's share of the net income in arriving at the *operator's* gross income, so that by deducting operating expense, the *operator's* net income is determined, as follows:

1. Operator's gross income (after deducting rents and royalties paid or accrued, *including* assignor's one-third share of net profits)	$70,000	
2. 27½ per cent thereof		$19,250

3. Operating expense	30,000	
4. Operator's net profit	$40,000	
5. 50 per cent thereof		$20,000
6. Percentage depletion allowable to operator (the lesser of items 2 and 5)		$19,250
7. Percentage depletion allowable to assignor, 27½ per cent of $20,000, his share of net profits		5,500
8. Total depletion allowable to operator and assignor, equal to 27½ per cent of their combined gross income of $90,000		$24,750

Thus the assignor's share of the net income must be treated, as to the assignor, as both gross income and net income from the property, as any royalty would be. No other solution consistent with the statute is mathematically possible.

3. The Commissioner assigns as a third reason for granting of the writ the fact that there are pending his petitions for certiorari in *Helvering v. Bankline Oil Co.*, No. 387, and in *Helvering v. O'Donnell*, No. 406. No. 387 involves percentage depletion, but the precise issue there seems to bear no relation whatever to the issue here. No. 406 does involve the question whether a share in the net profits is an interest in the source of the profits, but is otherwise unrelated. The petition in No. 406

urges the importance of the question as a reason for certiorari. But percentage depletion is a mere statutory rule of thumb. *Helvering v. Twin Bell Syndicate,* supra, p. 221. If the Commissioner is not satisfied with it as it is, certainly Congress has the power to revise it.

Conclusion

WHEREFORE, it is respectfully submitted that the petition for a writ of certiorari should be denied.

GEORGE T. ALTMAN,
Attorney for Respondent.

APPENDIX

Revenue Act of 1928, c. 852, 45 Stat. 791:

"Sec. 23. Deductions from Gross Income.

"In computing net income there shall be allowed as deductions:

* * * * *

"(b) Depletion.—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In the case of leases the deduction shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each. (For percentage depletion in case of oil and gas wells, see section 114 (b) (3).)

* * * * *

"Sec. 114. Basis for Depreciation and Depletion.

* * * * *

"(b) Basis for depletion.—

* * * * *

"(3) PERCENTAGE DEPLETION FOR OIL AND GAS WELLS.—In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph."

FILE COPY

Supreme Court, U. S.
FILED
JAN 31 1938
CHARLES ELMORE CROPLEY
CLERK

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, A. D. 1937

No. 446

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

ELBE OIL LAND DEVELOPMENT COMPANY,

Respondent.

Brief for Respondent.

GEORGE T. ALTMAN,
Counsel for Respondent.

CHICAGO LAW PRINTING CO., 111 N. WACKER DRIVE (COR. WASHINGTON ST.) TEL. FRANKLIN 0321

INDEX.

	PAGE
Opinions Below	1
Jurisdiction	1
Question Presented	2
Statutes Involved	2
Statement	2
Summary of Argument	5
Argument	7-27
I. The nature of the contract of October 3, 1927, must be based upon the ruling intention of the parties as determined, not from any one paragraph thereof, but from the entire contract and every part of it, and more especially from the paragraphs directed to particular matters	7
II. Upon a consideration of the entire contract, the transaction between the taxpayer and Honolulu did not constitute a sale	10
III. Honolulu's right to reimbursement from production does not make the transaction pro tanto a sale, nor affect the character of the payments involved as bonus or advance royalty	16
IV. The taxpayer's reserved right to share in the net profits of the well is an economic interest in the oil in place subject to depletion	23
Conclusion	28
Appendix	29

PAGE

CASES CITED.

Akin v. Marshall Oil Co., 188 Pa. 602, 41 Atl. 748, 751..10, 23
American Ideal Cleaning Co. v. Commissioner, 30 B. T. A. 529 13
Appeal of Kenefick, 3 B. T. A. 659, 663 13
Bandini Petroleum Co. v. Superior Court, 284 U. S. 8, 19 15
Banks v. Crow, 3 Or. 477 17
Barkhaus v. Producers' Fruit Co., 192 Cal. 200, 219 Pac. 435, 437 11
Baton Coal Co. v. Commissioner, (C. C. A. 3) 51 Fed. (2d) 469, certiorari denied, 284 U. S. 674 18
Billwiller's Estate v. Commissioner (C. C. A. 2), 31 F, (2d) 286, certiorari denied, 279 U. S. 866 23
Blair v. Commissioner, 300 U. S. 5, 13 23
Boyd v. Second Hand Supply Co., 14 Ariz. 36, 123 Pac. 619 17
Brown v. Fletcher, 235 U. S. 589, 598-9 23
Buckeye Buggy Co. v. Montana Stables, 43 Wash. 49, 85 Pac. 1077 17
Burnet v. Harmel, 287 U. S. 103, 106 ..... 17, 22
Commissioner v. Fleming, (C. C. A. 5) 82 F. (2nd) 324 ..... 21, 22
Creel v. Nettleton, 151 Wash. 440, 276 Pac. 91 17
General Utilities Co. v. Helvering, 296 U. S. 200, 206 12
Green County v. Quinlan, 211 U. S. 582 ..... 8, 9
Helvering v. Gowran, 302 U. S. ....., Decided December 6, 1937 12
Helvering v. Rankin, 295 U. S. 125, 131 12
Helvering v. Salvage, 297 U. S. 106, 109 ..... 12, 14
Helvering v. Twin Bell Syndicate Co., 293 U. S. 323 ..... 18, 24
Herring v. Commissioner, 293 U. S. 322, 324 ..... 16, 17, 21, 22
Heryford v. Davis, 102 U. S. 235, 243 8

PAGE

CASES CITED (continued).

Irwin v. Gavit, 268 U. S. 161, 167-8 23

Ladd v. Ladd, 8 How. 10, 28 7
Lewis v. Shell Oil Co., 230 Cal. 80, 29 Pac. (2d) 413.... 17
Lynch v. Alworth-Stephens Co., 267 U. S. 364, 370..... 23

McEachern v. Rose, 302 U. S. 56, 59-60 11
Minnesota Loan & Trust Co. v. Douglas, 135 Minn. 413, 161 N. W. 158, 162..... 23
Mohawk Oil Co. v. Hopkins, 196 Cal. 148, 152, 236 Pac. 133 15
Murphy Oil Co. v. Burnet, 287 U. S. 299, 304.....11, 17, 22
Mutual Life Insurance Co. v. Hill, 193 U. S. 551..... 8

O'Brien v. Miller, 168 U. S. 287..... 8

Palmer v. Bender, 287 U. S. 551.....9, 21, 22, 23, 24, 27
Petersburg Fire Brick & Tile Co. v. American Clay Machinery Co., 89 Ohio St. 365, 106 N. E. 33..... 17

Roach v. Summers, 20 Wall. 165, 170 13

Scheland v. Erpelding, 6 Or. 259 17
Senior v. Braden, 295 U. S. 429.....9, 23
Shiffman v. Richfield Oil Co. of California, 93 Cal. Decisions 114, 64 P. (2d) 1081 (1937).....10, 23
Sullivan v. Capital Traction Co., 34 App. D. C. 358, 368 14

Taplin v. Clark, 89 Vt. 226, 95 Atl. 491..... 17
Thomas v. Perkins, 301 U. S. 655.....17, 21, 24

Work v. Mosier, 261 U. S. 352, 357-8 22

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, A. D. 1937

No. 446

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

ELBE OIL LAND DEVELOPMENT COMPANY,

Respondent.

Brief for Respondent.

Opinions Below.

The opinion of the Board of Tax Appeals (R. 69-76) is reported in 34 B. T. A. 333. The opinion of the Circuit Court of Appeals (R. 86-91) is reported in 91 F. (2d) 127.

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered June 21, 1937 (R. 91). The petition for a writ of certiorari was filed September 21, 1937, and granted November 8, 1937 (R. 92). The jurisdiction of this Court is conferred by Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

Question Presented.

The question is whether the annual payments of $400,000 each received by the taxpayer in the years 1928 and 1929 under an agreement dated October 3, 1927, were "gross income from the property" within the meaning of that phrase as used in Section 114(b)(3) of the *Revenue Act of 1928*, so as to entitle the taxpayer to a depletion allowance of 27½ percent thereof under the provisions of that section.

Statutes Involved.

Section 23 (l) of the Revenue Act of 1928, under which the allowance for depletion is granted, and Section 114(b)(3) thereof, which prescribes the basis for the allowance under Section 23 (l) in the case of oil and gas wells, are correctly set forth by the Commissioner in his brief, pp. 2-4, and are shown herein in the Appendix, *infra*, pp. 29-30.

Statement.

The Commissioner's statement of facts, pp. 4-6 of his brief, is inaccurate and incomplete. On page 5, he says that the "consideration of $2,000,000 was to be paid without reference to and without being in any manner based upon the production of oil from the properties." The statement in the record cited to this effect (R. 71) is an inference of the Board from the contract of October 3, 1927 (R. 37-64). There is nothing in that contract requiring that the payments be made without reference to production. The payments to be made on March 14, 1928, and March 14, 1929, being the payments involved in this controversy, were optional with Honolulu (R. 54-58). Prior thereto, beginning as of October 3, 1927, Honolulu was already in possession of the properties under the contract (R. 34). Between October 3, 1927, and March 14, 1928, the date of the first optional payment, it (and its

assignee, Shell) spudded in and completed 5 wells; and between the latter date and March 14, 1929, the date of the second optional payment, it spudded in and completed 7 more wells (R. 67-68). There is nothing in the contract of October 3, 1927, which prevented Honolulu from considering the results of production in determining at the time of each optional payment, whether to make the payment or return the properties to the taxpayer. If, moreover, it decided to return the properties to the taxpayer, it retained the right to the possession of all oil wells which had been completed or were in process of drilling until such time as it had been reimbursed for all its expenditures, including the payments already made to the taxpayer (R. 55-58). And if it retained the properties, it was entitled to be reimbursed from production for these payments before any royalties were due the taxpayer on account of its one-third share in the net profits (R. 48-49). There is no basis, therefore, for the inference that the "consideration of $2,000,000 was to be paid without reference to and without being in any manner based upon the production of oil from the properties."

Again, on page 6 of his brief, the Commissioner says that on its return for 1927, the taxpayer treated the transaction as a sale. The pages in the record cited (35, 71) are barren of any such fact. It is a mere inference of the Commissioner, and will be considered herein under the head of Argument.

In addition to the facts stated by the Commissioner it should be observed that Honolulu bound itself to the taxpayer to perform all work and labor required under the permits and leases transferred to it and to pay the royalties required thereunder to the United States, the original permittees, and the original lessors (R. 45-47), provided, however, that it might surrender to the taxpayer the prop-

erties or any part thereof, and be thereupon released of said obligation assumed with respect to the properties surrendered (R. 60).

Moreover, Honolulu was required to render monthly statements of operations to the taxpayer (R. 59), with right in the taxpayer to examine the books of Honolulu and to have audits made of them (R. 59), and to come upon and examine any of the properties (R. 61). And from the very beginning Honolulu was required to pay the taxpayer, monthly, the latter's reserved one-third of the net profits from the properties after reimbursement of Honolulu for its expenditures under the contract, including the annual payments so far made to the taxpayer (R. 46-54).

SUMMARY OF ARGUMENT.

The nature of the contract of October 3, 1927, cannot be determined from any one paragraph thereof, but only from the entire contract and every part of it, and more especially from the paragraphs directed to particular matters. There is, also, no burden on the taxpayer to show that any paragraph of the contract was not a paper provision. Moreover, the charge that the provision reserving to the taxpayer a one-third interest in the net profits was a paper provision, that there was no reasonable expectation that any payments would be made under that provision, and that the transaction was therefore a purchase by Honolulu for $2,000,000 of an equivalent amount of oil in the ground, is utterly inconsistent with reality. In any case, that charge, being in the nature of an affirmative defense, is improper because now made by the Commissioner for the first time. At least, the taxpayer would be entitled to have the case remanded to the Board so that it might introduce evidence in this respect. Upon a consideration of the entire contract including the provision reserving to the taxpayer a one-third interest in the net profits, the transaction between Honolulu and the taxpayer was not a sale.

Nor does Honolulu's right to reimbursement make the transaction *pro tanto* a sale, nor does it affect the character of the payments involved as bonus or advance royalty. A sale, for $2,000,000, of an equivalent amount of oil in the ground, would not be reasonable. To so interpret the contract, moreover, would require a separation of the contract into two contracts, the one pertaining to reimburse-

ment out of production and the other pertaining to the share in the net profits. But the contract can only be interpreted as not separable.

There is, of course, a single allowance for percentage depletion which must be "equitably apportioned" between those entitled to share therein. However, this would not require denial of percentage depletion to the taxpayer on the payments here involved merely because Honolulu "owned" the oil produced to the extent necessary for reimbursement of those payments; for, as bonus, those payments would be deductible by Honolulu from the gross proceeds "owned" by it in computing its gross income for the purpose of percentage depletion. Thus, the necessity of ownership, as a basis for depletion, of the oil produced or proceeds thereof, does not apply to depletion on bonus or advance royalties.

Nor is the taxpayer to be denied depletion on the amounts thus received as bonus because its reserved interest in the properties is a right to share in the net profits instead of the gross. An interest in the net income from property is an interest in the property itself. The property here being oil, in place, an interest therein is necessarily depleted by production. It follows that the taxpayer's reserved interest is an interest in the oil in place, depleted by production. Moreover, denial of percentage depletion upon payments received out of net profits would be mathematically inconsistent with the statutory limitation on percentage depletion based on net income of the taxpayer from the property. Finally, the taxpayer here was the discoverer of the oil. The special depletion allowances having been granted by Congress because of its policy favoring the discoverer of the oil, that policy should not be defeated here merely because the reserved interest of the taxpayer was based on net instead of gross proceeds.

ARGUMENT.

I.

The nature of the contract of October 3, 1927, must be based upon the ruling intention of the parties as determined, not from any one paragraph thereof, but from the entire contract and every part of it, and more especially from the paragraphs directed to particular matters.

The Commissioner urges first that the contract between the taxpayer and Honolulu constituted a sale, and in support of that conclusion states that the contract "specifically provided that it was the intention of the parties that full and complete ownership of the properties should vest in Honolulu and the taxpayer should 'have no interest in or to any of said properties whatsoever.'" (Brief for Petitioner, p. 12.) Thus the Commissioner relies upon an expression of the parties as to the effect of the contract, contained in paragraph 3 thereof (R. 44-45). The effect of a contract, however, can only be determined from a consideration of every part of it, and more particularly from the paragraphs directed to particular matters.

This Court has dwelt often on this point involved in the interpretation of contracts. An instrument, this Court has held, should be interpreted by the context so as, if possible, to give a sensible meaning and effect to all its provisions; and so as to avoid rendering portions of it contradictory and void. *Ladd* v. *Ladd*, 8 How. 10, 28. Again, the true construction of a contract is not to be found in any name which the parties may have given to it, and not alone in any particular provisions it contains, disconnected from all other, but in the ruling intention of the

parties, gathered from all the language they have used. *Heryford* v. *Davis,* 102 U. S. 235, 243. Applying the rule to the facts, this Court there said, at page 245:

> "It is quite unmeaning for parties to a contract to say it shall not amount to a sale, when it contains every element of sale."

In another case, *O'Brien* v. *Miller,* 168 U. S. 287, a provision in a bottomry bond that it be void in case of complete loss of a named vessel was held not controlling when, there being two vessels involved in the bond, other provisions showed that the defeasance clause was intended to be effective only if both vessels were lost. In interpreting a contract, this Court there held, at page 297, the whole contract must be brought into view, and it must be interpreted with reference to the nature of the obligations between the parties, and the intention which they have manifested in forming them; and even the lack of ambiguity in certain words when standing alone does not necessarily relieve them from the necessity of construction in ascertaining the meaning of the entire contract.

Again, in *Green County* v. *Quinlan,* 211 U. S. 582, this Court pointed out, at page 594, that in ascertaining the true meaning of instruments in writing courts do not confine their attention to single words, phrases or sentences, but the meaning is sought from the whole instrument viewed in the light of the subject with which it deals, and the intent is thus reached though the result be to disregard technical meanings. In still another case, *Mutual Life Insurance Co.* v. *Hill,* 193 U. S. 551, a provision in a contract that it be considered as having been made in New York was held not to prevent its limitation by other express provisions, such as waiver of notice although New York law prohibited forfeiture without notice. Where

there are two clauses in a contract, this Court pointed out, at page 558, conflicting in any respect, that which is specially directed to a particular matter controls in respect thereto over one which is general in its terms, although within its general terms the particular may be included, and this because, when the parties express themselves in reference to a particular matter, the attention is directed to that, and it must be assumed that it expresses their intent, whereas a reference to some general matter, within which the particular may be included, does not necessarily indicate that the parties had the particular matter in thought.

All this must be especially borne in mind here; for in taxation our concern is with realities, not nomenclature. *Senior* v. *Braden*, 295 U. S. 429. In *Palmer* v. *Bender*, 287 U. S. 551, although the instrument used the words "sell, assign, set over, transfer and deliver," this Court referred to the cash payment of $3,000,000 involved, not as proceeds of a sale, but as a "cash bonus." Thus, as pointed out in *Green County* v. *Quinlan, supra*, the true meaning of the writing was not based on single words, phrases, or sentences, but on the whole instrument viewed in the light of the subject with which it dealt.

The conclusion must be that the entire contract, and every part of it, and more especially the paragraphs directed to particular matters, must be examined and given weight in determining the nature of the contract of October 3, 1927.

II.

Upon a consideration of the entire contract, the transaction between the taxpayer and Honolulu did not constitute a sale.

The reservation of interest by the taxpayer in the net profits of the properties transferred (R. 48-56); the requirement that Honolulu render monthly statements of operations to the taxpayer (R. 59); the reservation by the taxpayer of the right to examine the books of Honolulu and to have audits made of them (R. 59); the provision that Honolulu might secure release from this and all other obligations with respect to any of the properties by surrendering such properties to the taxpayer (R. 60); the reservation by the taxpayer of the right to come upon and examine any of the properties (R. 61);—all these are provisions in the contract with respect to the properties transferred wholly inconsistent with the notion of a sale. If Honolulu assigned to a third party the leases and permits transferred to it by the taxpayer, such third party, unless an innocent purchaser, would be accountable to the taxpayer in Honolulu's stead. *Shiffman* v. *Richfield Oil Co. of California,* 93 Cal. Decisions 114, 64 P. (2d) 1081 (1937). In the case last cited the interest involved was in the *net* proceeds and the court expressly held (p. 1088) that such an interest stood in the same position, as against assignees of the lease, as a percentage in the oil itself. See also *Akin* v. *Marshall Oil Co.,* 188 Pa. 602, 41 Atl. 748, 751. Thus the taxpayer here reserved a permanent interest in the properties transferred, good against anyone but an innocent purchaser. Where the transferor of a lease reserves any interest therein, whether it be a portion of the term, or some estate or interest in the premises, the trans-

fer is a sublease. *Barkhaus* v. *Producers' Fruit Co.*, 192 Cal. 200, 219 Pac. 435, 437. It is clear then that the transaction between the taxpayer and Honolulu was a sublease, not a sale.

The Commissioner now contends, however, that the taxpayer himself treated the transaction as a sale. (Brief for Petitioner, pp. 6, 7, 13.) There is nothing in the record to support this notion. The Commissioner predicates it entirely on the fact that in reporting its income for 1927 the taxpayer deducted from the payment of $350,000 received in that year under the contract, the entire cost of acquiring and developing the properties transferred. This the taxpayer did in accordance with *Murphy Oil Co.* v. *Burnet*, 287 U. S. 299, 304, where this Court sustained the Commissioner in treating an amount, received as bonus, as entirely a recovery of cost. The depletion allowance for 1927, under the statute, could not have been less than it would have been if computed without reference to percentage depletion.[1] It follows, therefore, that if the cost, deductible under the principle of the *Murphy Oil Co.* case, was greater than percentage depletion, that is, 27½ per cent of $350,000, such cost was the proper amount to be deducted for 1927 *as depletion*. The deduction by the taxpayer of the entire cost in 1927 is thus no basis for the conclusion that the taxpayer himself treated the transaction as a sale. Even if the taxpayer had, in 1927, erroneously treated the transaction as a sale, or erroneously deducted the entire cost, that would be no basis for any conclusion here. *McEachern* v. *Rose*, 302 U. S. 56, 59-60. There are no grounds for

---

1. U. S. C. A., Title 26, Par. 935, quoted in *Helvering* v. *Twin Bell Syndicate*, 293 U. S. 312, 314. It will be observed that the statutory provisions covering percentage depletion for 1927 were the same as for the years here involved and set out in the Appendix, *infra*, pp. 29-30.

estoppel; nor does the Commissioner raise that issue; nor has he heretofore raised it so as to be entitled to present it now. *General Utilities Co.* v. *Helvering,* 296 U. S. 200, 206; *Helvering* v. *Salvage,* 297 U. S. 106, 109.

The Commissioner, however, observing that the transaction between the taxpayer and Honolulu may not be a sale in view of the taxpayer's reservation, under paragraph 8 of the contract, of an interest in the net profits of the properties, now charges that no reasonable expectation exists that payments ultimately will be made under paragraph 8—that paragraph 8 may have been nothing more than a paper provision. (Brief of Petitioner, pp. 13-14.) This is a complete shift of ground. Never before in this proceeding has the Commissioner presented that ground. At least the taxpayer would be entitled to have the case remanded to the Board so that it might have an opportunity to submit evidence on the point. *Helvering* v. *Gowran,* 302 U. S. ....., decided December 6, 1937; *Helvering* v. *Rankin,* 295 U. S. 125, 131. The taxpayer is prepared to present evidence showing that production was slowed up by proration,[2] and that there is a reasonable expectation that payments will be made under paragraph 8.[3]

---

2. Curtailment of oil production under proration agreements and statutory provisions has been common in this country for several years. Beginning in 1930, Congress recognized the importance of such agreements for the purpose of conservation of natural resources. It authorized them on lands held under federal permit, and required that they vest in the proper federal department control over the rate of prospecting, development and production. 30 U. S. C. A., Par. 184, 226, as amended by 46 Stat. 1007, 1523.

3. Far from being secret, production and reserve data with respect to particular oil fields are widely published. Voluminous detail with respect to the "Round Mountain" field, the oil field herein involved (R. 66), as of the time

Such remand, however, should not be necessary. It may be true that the burden is upon the taxpayer to establish its right to the depletion allowance. But that does not place upon it the burden of showing that any paragraph of the contract involved was not a paper provision. The taxpayer's burden of proof does not require it to negative all possible defenses; the Commissioner's affirmative defenses are for him to prove. *Appeal of Kenefick,* 3 B. T. A. 659, 663; *American Ideal Cleaning Co.* v. *Commissioner,* 30 B. T. A. 529; *Roach* v. *Summers,* 20 Wall. 165,

---

when this proceeding was before the Board (the stipulations were filed September 18, 1933, and January 30, 1934,—R. 2) can be found in several publications. In *Petroleum World,* 1934 Annual Review (Library of Congress catalog number TN860.P6), there appears, on pages 74-94, a complete detail of production and potentials in California for 1933. Only three companies are therein indicated to have had wells in the "Round Mountain" field in 1933: California Western Oil Co. (page 77) with 1 well and potential of 79 barrels per day, Honolulu (page 82) with 9 wells and potential of 5,430 barrels per day, and Shell (page 89) with 24 wells and potential of 4,260 barrels per day. (A detail of the wells of Honolulu and its assignee, Shell, as of approximately the same time, is given in the record, R. 67-68). Thus the properties involved in this proceeding are shown to have represented 33 out of 34 wells and a potential of 9,690 barrels per day out of a total potential of 9,769 in the "Round Mountain" field, or 99.2%.

Estimates of the available oil reserve of the "Round Mountain" field are given in the same publication, page 30, also in the *Oil and Gas Journal* (Library of Congress catalog number TN860.O4) for September 20, 1934, page 55, and also in the 1934, 1935, and 1936 volumes of *Petroleum Development and Technology* (a publication of the American Institute of Mining and Metallurgical Engineers, Library of Congress catalog number TN860.A4). As in-

170; *Sullivan* v. *Capital Traction Co.*, 34 App. D. C., 358, 368. The defense being affirmative, and not having been presented to the Board, nor to the Court below, it cannot be presented now. *Helvering* v. *Salvage, supra.*

The Commissioner, moreover, himself indirectly denies that the provision for payments under paragraph 8 was a mere paper provision; for he admits (p. 23 of his brief) that the parties took the trouble to set up an elaborate mechanism for their computation. Furthermore, the

---

dicated in the latter publication (1934 volume, pages 189-192, lines 23 and 35), the estimates of the remaining reserves as of January, 1934, ranging from 35,000,000 to 45,000,000 barrels, include "Coffee Canyon" field, which was later segregated in that publication with an estimate of 8,000,000 barrels as of the same date (1935 volume, pages 259-266, line 68.) Thus the estimated remaining reserves of the "Round Mountain" field as of January, 1934, as reported in these publications, range from 27,000,000 to 37,000,000 barrels. A report of J. R. Pemberton, Oil Umpire for Central Committee of California Oil Producers, as of January, 1935, entitled "Vital Statistics of California Oil Fields," and showing a reserve of 31,500,000 barrels for "Round Mountain," may be had in the office of Edward B. Swanson, Associate Director of Conservation, Room 7315, U. S. Department of Interior, South Building, Washington, D. C.

The prices of "Round Mountain" oil, at the well, are indicated in the same issue of *Petroleum World* mentioned above, page 63, to have ranged from 49¢ to 57¢ per barrel during the period from October 22, 1928, up to 1934. Thus at the time the stipulations of fact were filed with the Board in this proceeding, the published estimates indicate the remaining available oil in the "Round Mountain" field to have been worth, at the well, from $14,000,000 to $20,000,000. Of this amount the properties involved in this proceeding, as determined by the published reports of potential in barrels per day, represented, as pointed out above, 99.2%.

notion that paragraph 8 was a paper provision is impossible. If there was no reasonable expectation of payments to the taxpayer out of its one-third share in the net profits, under paragraph 8, it necessarily follows that there was no reasonable expectation by Honolulu of any net profits. To assert that Honolulu would pay out $2,000,000 in money for the chance to recover an *equivalent* amount out of oil in the ground, plus 2½%, or any other percentage, is an attack upon human reason itself. The migratory and uncertain nature of oil has often been a matter of judicial notice. *Bandini Petroleum Co.* v. *Superior Court*, 284 U. S. 8, 19; *Mohawk Oil Co.* v. *Hopkins*, 196 Cal. 148, 152, 236 Pac. 133. One might invest $2,000,000 in Government bonds at 2½%; in industrial bonds, possibly at 5% or 6%; but no reasonable person would invest $2,000,000 in oil in the ground unless the estimates showed a possible realization of several times that amount.

The taxpayer submits, therefore, that the charge that paragraph 8 may be a paper provision is inconsistent with reality; that there is no burden upon the taxpayer to show that paragraph 8 or any other paragraph was not a paper provision; that the charge is now made by the Commissioner for the first time and should not be considered by this Court; that the taxpayer would at least be entitled to have the case remanded to the Board so that it might introduce evidence in this respect; and that in the light of the entire contract, including paragraph 8, the transaction between the taxpayer and Honolulu was not a sale.

III.

Honolulu's right to reimbursement from production does not make the transaction pro tanto a sale, nor affect the character of the payments involved as bonus or advance royalty.

The mere fact that the amounts involved here were payments in advance for oil to be extracted is no objection to an allowance for depletion. This Court stated in *Herring* v. *Commissioner*, 293 U. S. 322, at page 324:

> "A bonus is not proceeds from the sale of property, but payment in advance for oil and gas to be extracted, and is therefore taxable income. As such it is 'gross income from the property' as the phrase is used in Section 204 (c) (2) to designate the base for the application of the percentage depletion."

The Commissioner, however, attempts a distinction by asserting that, inasmuch as Honolulu was entitled to be reimbursed out of production for the payments to the taxpayer totaling $2,000,000, that it had, in effect, purchased an *equivalent* amount of oil from the taxpayer (Brief of Petitioner, pp. 15-22). The notion is clearly impossible. As pointed out above, no reasonable person would pay out $2,000,000 for an equivalent amount of oil in the ground. The payment can only be considered reasonable, or at all sensible, in the light of the entire contract. As such it was advance royalty or bonus, since Honolulu was thereby entitled to continue operating the properties throughout the terms of the leases, paying to the taxpayer one-third of the net profits derived therefrom.

This is, moreover, an attempt on the part of the Commissioner to separate the contract into two contracts, the one pertaining to reimbursement out of production and the other pertaining to the share in the net profits. But the separability of a contract is a question of the inten-

tion of the parties to be determined from the nature of the subject matter and the language of the parties. *Lewis* v. *Shell Oil Co.*, 230 Cal. 80, 29 Pac. (2d) 413. When there is no apportionment of the consideration to the subject matter, the contract is entire and not separable. *Creel* v. *Nettleton*, 151 Wash. 440, 276 Pac. 91; *Buckeye Buggy Co.* v. *Montana Stables*, 43 Wash. 49, 85 Pac. 1077; *Scheland* v. *Erpelding*, 6 Or. 259; *Banks* v. *Crow*, 3 Or. 477; *Boyd* v. *Second Hand Supply Co.*, 14 Ariz. 36, 123 Pac. 619; *Petersburg Fire Brick & Tile Co.* v. *American Clay Machinery Co.*, 89 Ohio St. 365, 106 N. E. 33; *Taplin* v. *Clark*, 89 Vt. 226, 95 Atl. 491. There is no apportionment expressed in the terms of the contract; and an attempt to read into the contract because of the reimbursement provision an apportionment of the $2,000,000 paid to an equivalent amount of oil in the ground would, as already shown, result in an absurdity. The amount paid squares with reason only as a bonus or advance royalty with respect to the entire contract; and as such it is gross income from the property. *Burnet* v. *Harmel*, 287 U. S. 103, 106; *Murphy Oil Co.* v. *Burnet, supra*, 287 U. S. at 302; *Herring* v. *Commissioner, supra.*

The Commissioner urges that a contrary result is to be derived from *Thomas* v. *Perkins*, 301 U. S. 655. There leases were assigned in consideration of the right to receive one-fourth of all oil produced up to an aggregate amount of $395,000. This Court held that the assignor had reserved an interest in the property, to the extent of $395,000, subject to depletion. The Commissioner contends that the interest thus reserved is similar to the one acquired by Honolulu with respect to the amount of oil necessary to reimburse it for its payments to the taxpayer; that, therefore, Honolulu is entitled to depletion with respect to that amount and not the taxpayer. The Commissioner disregards the wide difference in the nature of the transactions. The amounts there received

by Perkins' assignors were gross income to them in their entirety. Here Honolulu, having paid a bonus, is entitled to deduct from the gross receipts from the property each year, an allocable portion of the bonus as rent or royalty. This applies in determining the net income on which the tax is based. *Baton Coal Co.* v. *Commissioner,* (C. C. A. 3) 51 Fed. (2d) 469, certiorari denied, 284 U. S. 674, sustaining the Commissioner and the Board. It applies also in determining the "gross income from the property" on which percentage depletion is based. The Commissioner himself concedes this, for he says (page 20 of his brief): "A true bonus—under the prevailing and plainly correct practice of the Bureau of Internal Revenue—is spread over the entire expected production of the well in computing the depletion allowance of the operator. The allocation is accomplished by deducting from the actual gross proceeds of the operator in the year of production—in order to arrive at the operator's 'gross income from the property'—an amount per barrel equal to the total estimated number of barrels in the well divided by the amount of the bonus."

Thus here, the taxpayer being entitled to depletion on the bonus, Honolulu's depletion is based on its gross receipts less the bonus. As a result, there is no conflict between the taxpayer and Honolulu with respect to their rights to the depletion allowance. The rule laid down in *Helvering* v. *Twin Bell Syndicate Co.,* 293 U. S. 323, that percentage depletion cannot be claimed upon an aggregate basis in excess of 100 per cent of the gross income is thus maintained.

On the Commissioner's theory, on the other hand, the 100 per cent rule of the *Twin Bell Syndicate* case could have no application. He contends that Honolulu purchased, for $2,000,000, an equivalent amount of oil. But the paragraph of the statute relating to percentage de-

pletion (see Appendix, *infra*, p. 30) provides that "in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph." Percentage depletion at 27½ per cent of gross income would necessarily be less than cost depletion where cost is equal to gross income. Thus the Commissioner attempts to apply the 100 per cent rule with a theory which *ipso facto* makes its application impossible.

The Commissioner asserts, however, that the payments here involved cannot, in computing Honolulu's gross income from the property, be spread as a bonus over the entire expected production, because the "terms of the agreement forbid their being spread throughout the life of the well" (Brief of Petitioner, p. 21). The Commissioner, of course, cannot mean that there is anything in the agreement forbidding the proper application of the revenue laws. Perhaps he is concerned by the resulting mathematics.[4] But mathematics far more complicated are

---

[4]Adopting the Commissioner's illustration (page 21 of his brief, note 5), suppose that the oil is expected to bring $1.00 a barrel, and that the lessee is entitled to recover the bonus of $100,000 out of production before the lessor's one-eighth royalty begins. Thus the first 100,000 barrels would go entirely to the lessee, plus seven-eighths of the remaining 300,000 barrels, or a total of 362,500 barrels. He has thus paid an advance royalty of $.2759 a barrel. (The Commissioner apparently meant $.2857 instead of $.35 a barrel in his illustration.) However, to even the effect of the one-eighth royalty over the entire production, the advance royalty can be spread over the first 100,000 barrels at $.34375 a barrel, and over the remaining 262,500 barrels going to the lessee at $.25 a barrel. If 10,000 barrels are produced by him in the first year, the sum of $3,437.50 will be deducted by him from the gross proceeds thereof as representing advance royalties; and his deduction for depletion will be 27½ per cent of the remainder.

familiar to the revenue laws and to the Treasury Department.[5] Certainly the taxpayer is not to be denied an allowance for depletion because an extra step is required in the calculation. The statute involved, moreover, requires that the deduction for depletion be "equitably apportioned"; and it would hardly be consonant with equity to give the entire deduction to Honolulu, and deny any to the taxpayer merely because Honolulu was entitled to be reimbursed out of production for the bonus before royalties were due the taxpayer.

The Commissioner further contends, however, that Honolulu "owned" the oil out of which the bonus was to be recovered. He concedes that an interest in the oil property, to be depletable, "need not consist of any form of legal ownership of the mineral content of the land" (Brief of Petitioner, p. 9). He also concedes that in the case of a bonus, the recipient of the bonus is entitled to depletion thereon, and that the gross income of the operator in such

---

Applying the above method to the situation here, suppose an expected total production of 40,000,000 barrels and an expected average price of $.50 a barrel, after deducting royalties payable to the original lessors and permittees. Suppose further an average cost of development and production of $.25 a barrel, so as to leave a net profit of $.25 a barrel. The result is that 8,000,000 barrels will be required to reimburse Honolulu for the $2,000,000 bonus paid the taxpayer. The remaining 32,000,000 barrels will, at the same profit of $.25 a barrel, give the taxpayer one-third thereof, or $.08⅓ a barrel. In order to even the effect of this $.08⅓ royalty over the entire production, the $2,000,000 bonus would be spread at the rate of $.11⅔ a barrel on the first 8,000,000 barrels and $.03⅓ a barrel on the remaining 32,000,000 barrels.

[5]See, for example, Treasury Regulations 94, Art. 131-8, and Treasury Regulations 80, Art. 8. See also *Interdependent Taxes,* Commerce Clearing House, Inc. (1937).

case is not the gross proceeds retained by him and obviously owned by him, but such gross proceeds *less an allocable share of the bonus* (Brief of Petitioner, pp. 20-21).[6] He thus concedes that in the case of a bonus a part of the gross proceeds *owned* by the operator represents the depletable interest, not of the operator, but of the person to whom he paid the bonus. On the Commissioner's own presentation, therefore, the necessity of ownership of the oil produced or proceeds thereof during any period does not apply to depletion on bonus or advance royalties. In fact, as shown in *Herring* v. *Commissioner, supra,* it is immaterial whether any production took place during the period involved.

The case of *Thomas* v. *Perkins, supra,* cited by the Commissioner in this connection (pp. 10, 17, 22 of his brief) involved no bonus or advance royalty; and the Commissioner does not contend that it did. He points also (p. 22 of his brief) to the case of *Commissioner* v. *Fleming,* (C. C. A. 5) 82 F. (2nd) 324. The reserved interest of Fleming, however, was limited in aggregate amount, after payment of which he would have no interest left whatever, although production might have hardly begun. Fleming had thus reserved no permanent interest in the property on the basis of which the cash payment could be spread as bonus over the entire expected production of the wells. The Court there itself pointed out, at page 327: "In *Palmer* v. *Bender,* however, the transferor reserved an additional royalty, and so was in reality a sublessor, and the cash paid him could more readily be treated as a bonus

---

[6] In his illustration, page 21 of his brief, he points to the *lessee's share* of 10,000 barrels in the first year's production but yet excludes from the gross proceeds thereof $3,500 as advance royalties on which depletion was properly taken by the lessor.

or advance royalty." Here, as in *Palmer* v. *Bender*, the taxpayer had reserved a permanent interest in the properties; and Honolulu was responsible *to the taxpayer* for performing the work required and other obligations under the leases and permits transferred to it, and could only terminate that responsibility by surrendering the propties *to the taxpayer*. The notion of a sale of all the taxpayer's interest except that reserved, applied by the Circuit Court in the *Fleming* case, is therefore not applicable here. It could as well be applied to any transfer for bonus and royalty. Thus, in the Commissioner's illustration (p. 21 of his brief, n. 5) the transaction could be treated as a sale by the lessor, for $100,000, of seven-eighths of the oil in the ground. Again, the transfer in *Palmer* v. *Bender*, supra, for bonus, oil payments aggregating $1,000,000, and a one-eighth excess royalty, could be treated as a sale, for the amount of the bonus, of seven-eighths of the oil in the ground less the amount of the oil payments. The same thing could be done in *Burnet* v. *Harmel*, *Murphy Oil Co.* v. *Burnet*, and *Herring* v. *Commissioner*, *supra*. But this Court in all of these cases condemned the notion of a sale for the amount of the bonus and held the bonus to be gross income from the property. This principle was firmly established even before it became an issue in connection with the income tax. See *Work* v. *Mosier*, 261 U. S. 352, 357-8. Thus, to apply the theory of the Commissioner as he contends would mean uprooting fundamental principles long recognized by this Court.

IV.

The Taxpayer's Reserved Right to Share in the Net Profits of the Well is an Economic Interest in the Oil in Place Subject to Depletion.

The Commissioner attempts, finally, to distinguish the taxpayer's reserved interest because it is measured by the net profits of production instead of by the gross. The distinction is without foundation. One who owns a share in the net income from property has an interest in the property itself. *Brown* v. *Fletcher*, 235 U. S. 589, 598-9; *Irwin* v. *Gavit*, 268 U. S. 161, 167-8; *Senior* v. *Braden*, 295 U. S. 422, 432-3; *Blair* v. *Commissioner*, 300 U. S. 5, 13. Under the law of California, where the property here involved is situated (see map, R. 66), a share in the net profits of oil leases is an interest in the property good against any one but an innocent purchaser. *Shiffman* v. *Richfield Oil Co.*, *supra*. The payments covering such a share in the net profits of oil property are regarded as royalty or rent. *Minnesota Loan & Trust Co.* v. *Douglas*, 135 Minn. 413, 161 N. W. 158, 162; *Akin* v. *Marshall Oil Co.*, 188 Pa. 602, 41 Atl. 748, 751. The deduction of interest at 2½ per cent on Honolulu's advances, in computing the net profit payable to the taxpayer, is immaterial; it is merely a way of distributing profits. *Billwiller's Estate* v. *Commissioner* (C. C. A. 2), 31 F. (2d) 286, certiorari denied, 279 U. S. 866, sustaining the Commissioner. That a share in the net profits of oil property is exhaustible by production is obvious. Thus its owner has an economic interest in the oil in place which is depleted by production. It must follow that he is entitled to the depletion allowance. *Lynch* v. *Alworth-Stephens Co.*, 267 U. S. 364, 370; *Palmer* v. *Bender*, 287 U. S. 551, 557.

The Commssioner refers to his brief in No. 406, pages 7-11. He says there (p. 8) that this Court in *Palmer* v. *Bender, supra,* rejected the criterion of legal ownership of the oil and gas in place for the criterion of ownership of the mineral or its proceeds as produced. There is nothing in *Palmer* v. *Bender* to warrant such a conclusion. This Court did say there (at p. 557) that if the lessor has retained a right to share in the oil produced he has an economic interest in the oil in place, which is depleted by production. It did not say that *only* a right to share in the oil produced represented an economic interest in the oil in place, nor did it say that a right to share in the net profits of the well did not constitute an economic interest in the oil in place. Nor can any such statement be found in *Helvering* v. *Twin Bell Syndicate,* nor in *Thomas* v. *Perkins.* In *Thomas* v. *Perkins* this Court stated, as quoted by the Commissioner in his brief here, at page 10: "If Palmer had retained no interest in the oil he would have been entitled to no deduction on account of depletion. Ownership was essential." It did not say that an interest measured by net profits was not an interest in the oil. It did not say that the ownership which was essential was any particular type of ownership, nor that ownership of a share in the net profits of the well was not sufficient. It is the oil in place which is depleted by production—*Palmer* v. *Bender, supra,* at 557, where this Court said: "If so he has an economic interest in the oil, in place, which is depleted by production." The statute requires that the allowance for such depletion be "equitably apportioned." *Thomas* v. *Perkins, supra,* at 662. The apportionment must depend then upon the interests in the oil in place, and the shares appearing in the gross or net proceeds are only the measure of those interests. Quoting from *Helvering* v. *Twin Bell Syndicate,* this Court in *Thomas* v. *Perkins* stated, at page 662: " 'The apportionment gives respond-

ent 27½ per cent of the gross income from production which it had the right to *retain* and the assignor and lessor respectively 27½ per cent of the royalties they receive. Such an apportionment has regard to the economic interest of each of the parties entitled to participate in the depletion allowances.'" (Italics supplied.) Honolulu does not *retain* the royalty which it pays over to the taxpayer merely because that royalty is measured by net instead of gross proceeds.

In its brief in opposition to certiorari, pages 8-10, the taxpayer pointed out that the very provision of the statute granting percentage depletion based a limitation on the net income from the property; and that the application of this limitation makes the Commissioner's contention mathematically impossible. An example was set out showing that the Commissioner's contention would result in excluding from the net profits the taxpayer's share thereof without any accounting at all. The Commissioner now refers to this argument of the taxpayer's and says (p. 25 of his brief): "No argument or authority is offered to show that the amounts payable to Elbe would not be included within Honolulu's net taxable income." In other words, asks the Commissioner, if the net profits from the property are $60,000, and of this one-third or $20,000 is paid over to the taxpayer as its share under the contract, what argument or authority is offered to show that *Honolulu's* net profit is only $40,000? Is argument or authority necessary? The problem is not one of law but of simple arithmetic. This is true, not only with respect to net taxable income, but also with respect to the net income on which the limitation on depletion is based. The latter, it is to be observed, is not merely the net income from the property, but the net income *of the taxpayer* from the property. (See Appendix, p. 30.)

The Commissioner further says that, even so, the "asserted exclusion of the amounts in question from 'an accounting' would not be invariable, but would depend upon the amount of the operating expense and the size of the share of net profits payable in the particular case." The limitation based on net income is, of course, a limitation on the allowance; and the effect of any limitation depends upon the variables governed by the limitation.[6] The Commissioner is merely defining the term "limitation." In computing the limitation, however, the exclusion of the taxpayer's share of net profits without any accounting at all as a result of the Commissioner's contention would be invariable. It can be demonstrated mathematically that as the statute reads the limitation is required to become effective when the operating expense exceeds 45 per cent of the gross income.[7] As a result of the Commissioner's contention the limitation would become effective when the operating expense exceeds only 17½ per cent of the gross income.[8] This is mathematics purely; and the Commissioner's contention violates the plain words of the statute.

The Commissioner recalls with approval (page 25 of his brief) the taxpayer's statement that percentage depletion

---

[6]See Milne, *Academic Algebra*, pages 378-386, Library of Congress catalog number QA152.M65.

[7]Let G=Gross Proceeds
O=Operating Expense
Then Percentage Depletion $=.27\frac{1}{2}G$
Limited, however, to $.50(G-O)$
Therefore, the limit becomes effective when $.27\frac{1}{2}G=.50(G-O)$
Solving for O, $O=.45G$

[8]The corresponding equation would be $.27\frac{1}{2}G=.50(G-O)\frac{2}{3}$
Solving for O, $O=.17\frac{1}{2}G$

is merely a statutory rule of thumb, but contends that the operation of such a rule, on occasion, with apparent arbitrariness, is no ground for rejecting a meaning "which otherwise is plain." The taxpayer agrees with this contention. The Commissioner's argument that the taxpayer's share of the net profits is also Honolulu's net profits, and his attempt to deny the rudimentary principles of mathematics, are no tribute to the plainness of his meaning. On the contrary, his meaning is mathematically in conflict with the plain words of the statute.

It may be observed also that the taxpayer is the discoverer of the oil (R. 34, 70). It is therefore of the very class favored by the policy of the law—for whose benefit, primarily, the special depletion provisions have been enacted. *Palmer* v. *Bender, supra,* pages 558-559. If the taxpayer may borrow the words of this Court there, it would be a strange anomaly if the policy of the law were to be defeated because the taxpayer stipulated for royalties measured by net instead of gross proceeds.

CONCLUSION.

For the reasons stated it is submitted that the respondent had at all times an economic interest in the oil properties involved which is depleted by production; that the payments received by it in 1928 and 1929 in connection with those properties were bonus or advance royalty; that as a result such payments were "gross income from the property" within the meaning of that phrase as used in Section 114(b)(3) of the Revenue Act of 1928, so as to entitle it to a depletion allowance of 27½ per cent thereof; and that the judgment of the Circuit Court of Appeals was therefore correct and should be affirmed.

GEORGE T. ALTMAN,
Counsel for the Respondent.

January, 1938.

APPENDIX.

Revenue Act of 1928, c. 852, 45 Stat. 791:

"Sec. 23. Deductions from Gross Income.

"In computing net income there shall be allowed as deductions:

* * *

"(l) Depletion.—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In the case of leases the deduction shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each. (For percentage depletion in case of oil and gas wells, see section 114(b) (3).)

* * *

"Sec. 114. Basis for Depreciation and Depletion.

* * *

"(b) Basis for depletion.—

* * *

"(3) PERCENTAGE DEPLETION FOR OIL AND GAS WELLS.—In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph."

SUBJECT INDEX

	PAGE
Foreword	1
Jurisdiction	2
Reasons Submitted:	
(A) For Granting Rehearing	2
(B) For Granting a Rehearing or Amendment of Judgment	2
Discussion of Reasons for Granting Rehearing	3
I. There is a Clear Conflict Within the Opinion of This Court Rendered Herein, and Eliminating This Conflict the Opinion in Itself Supports Respondent Instead of the Government	3
II. This Court Has Erroneously Assumed That the Net Income is Something Wholly Distinct From the Gross Income, Instead of, as It Is, a Part of the Gross Income Itself	11
Discussion of Reason For Granting a Rehearing or Amendment of Judgment	12
I. The Decision of This Court is Based Upon a Mixed Issue of Law and Fact Not Raised at All Before the Board, Nor Before the Court Below, Nor Fairly Raised in the Government's Petition or Brief Filed in This Court	12
Conclusion	14
Certificate	15

CITATIONS AND AUTHORITIES

	PAGE
Akin v. Marshall O. Co., 188 Penn. 602, 41 Atl. 748	8
Blair v. Commissioner, 300 U. S. 5	5
Burnet v. Sanford etc., 282 U. S. 359	9
Corliss v. Bowers, 281 U. S. 376	9
Corpus Juris, Vol. 65, p. 277	8
Freuler v. Helvering, 291 U. S. 35, 45	5
Helvering v. Gowran, 302 U. S. (Dec. 6, 1937)	3, 11
Helvering v. O'Donnell (No. 406)	3
Outlet Emb. Co. v. Derwent etc., 254 N. Y. 179, 172 N. E. 462, 70 A. L. R. 1440	4
Poe v. Seaborn, 282 U. S. 101, 110	5
Revenue Act of 1928, Ch. 852, 45 Stats. 791, Sec. 114 (b) (3)	12
Schiffman v. Richfield O. Co., 93 Cal. Dec. 114, 64 P. (2d) 1081	6
Sharp v. Commissioner, (U. S.), (decided March 14, 1938)	5
Spindle v. Shreve, 111 U. S. 542	5
Thomas v. Perkins, 301 U. S. 655	14
Treasury Regulations 74, Art. 354	10
Tyler v. United States, 281 U. S. 487	9
Uterhart v. United States, 240 U. S. 598	5

In the Supreme Court

OF THE

United States

October Term, 1937

GUY T. HELVERING, Commissioner of Internal Revenue,

Petitioner,

vs.

ELBE OIL LAND DEVELOPMENT COMPANY,

Respondent.

Petition For Rehearing, or For Amendment of the Judgment of This Court Herein Granting Respondent Leave to Apply to the Board For Opportunity to Establish Additional Facts Which Would Affect the Result.

Respondent petitions this Court for a rehearing in this cause, or for amendment of the judgment of this Court herein granting respondent leave to apply to the Board for opportunity to establish additional facts which would affect the result. All three reasons submitted below are submitted as ground for rehearing, and the third reason is also submitted as ground for the amendment of judgment.

Jurisdiction

The judgment of this Court herein was entered March 7, 1938. This petition is filed within less than twenty-five days thereafter, under Rule 33 (28 U. S. C. A. ¶354).

REASONS SUBMITTED

A. For Granting a Rehearing

I. There is a clear conflict within the opinion of this Court rendered herein, and eliminating this conflict the opinion in itself supports respondent instead of the Government.

II. This Court has erroneously assumed that the net income is something wholly distinct from the gross income, instead of, as it is, a part of the gross income itself.

B. For Granting a Rehearing or Amendment of Judgment

I. The decision of this Court is based upon a mixed issue of law and fact not raised at all before the Board, nor before the Court below, nor fairly raised in the Government's petition or brief filed in this Court.

DISCUSSION OF REASONS FOR GRANTING A REHEARING

I.

There is a Clear Conflict Within the Opinion of This Court Rendered Herein, and Eliminating This Conflict the Opinion in Itself Supports Respondent Instead of the Government.

The decision rendered by this Court rests entirely upon the following three propositions:

1. That respondent made "an absolute sale of all the properties in question, including all the oil and gas in place."

2. That with respect to the same specific properties, after Honolulu had been fully reimbursed as provided in the agreement, respondent was to "receive monthly one-third of the net profits resulting from the production and operation."

3. That such provision entitling respondent to a share of the net profits was "a personal covenant of the Honolulu Company" giving the respondent no "equitable interest in the *res*."[1]

It is submitted that the above three propositions cannot stand together. If, in accordance with the *first* proposition, the transaction constituted an absolute sale to Honolulu of "all the properties in question, including all the

[1]The quotation, "equitable interest in the *res*," is taken from *Helvering v. O'Donnell*, No. 406, cited by the Court on this point.

oil and gas in place," then Honolulu could in turn sell all the oil and gas in place to a third party. Suppose Honolulu did so sell all the oil and gas in place to a third party. If now respondent's right, conceded under the *second* proposition, to a share in the "net profits from the production and operation," was, in accordance with the *third* proposition, a "personal covenant of the Honolulu Company" giving respondent no "equitable interest in the *res,*"—then respondent would have to look to Honolulu for net profits from the production and operation of properties in which Honolulu had no right, title or interest, as to which, in fact, Honolulu had no right even to know what the net profits were. Such a result would make of respondent's right to net profits a nullity and an absurdity. May we then quote again, as we did in oral argument, from Cardozo, Chief Judge, in *Outlet Embroidery Co. v. Derwent Mills*, 254 N. Y. 179, 172 N. E. 462, 70 A. L. R. 1440 (at page 463, N. E.):

> "To read the reservation thus is to rob it of its efficacy as an implement to be used in furtherance of a business purpose. In the transactions of business life, sanity of end and aim is at least a presumption, albeit subject to be rebutted. The defendant like the plaintiff supposed that in signing these documents it was doing something understood to be significant and serious. * * * Was it all sound and fury, signifying nothing?
>
> "If literalness is sheer absurdity, we are to seek some other meaning whereby reason will be instilled and absurdity avoided. * * * In the setting of the occasion, no other interpretation was possible for any reasonable mind."

Thus we are led inescapably to the conclusion that respondent's right to share in the net profits from production and operation was, because of the very nature of the right itself, at least an equitable interest in the *res*. Of the three propositions shown above, then, as derived from this Court's opinion, the second stands in necessary conflict with the other two. Respondent suggests that this conflict within the opinion of this Court herein has resulted from its effort to restrict the "economic interest" doctrine of *Palmer v. Bender*, 287 U. S. 551, to ownership recognizable at law or in equity, and at the same time set up its own criteria of such ownership so as to avoid the variations, if any, of local law. This is impossible, since such ownership is determined wholly by the law of the situs. If, according to the law of the situs, a person has no rights in a piece of property, this Court cannot give him any, nor if he has such rights can this Court deny their existence. For that reason this Court has consistently held that with respect to ownership, or property rights generally, decisions of the courts of the State of situs, particularly of the highest court of such State, are binding upon this Court.

Spindle v. Shreve, 111 U. S. 542, 547, 548;
Uterhart v. United States, 240 U. S. 598, 603;
Poe v. Seaborn, 282 U. S. 101, 110;
Freuler v. Helvering, 291 U. S. 35, 45;
Blair v. Commissioner, 300 U. S. 5, 9, 10;
Sharp v. Commissioner, ... U. S. ..... (decided March 14, 1938).

It was because of this determinative effect of the law of the situs that respondent, the properties involved in the contract here being California property, cited twice in its brief a decision handed down only last year by the Supreme Court of California, *Schiffman v. Richfield Oil Co.*, 93 Cal. Dec. 114, 64 Pac. (2d) 1081, holding that a right to share in net profits of oil leases was enforceable in equity against the *res*. The record here shows that a portion of the properties were transferred by Honolulu to Shell (R. 65, 67-68). There is no provision in the contract for payment to respondent because of any such transfer; respondent's interest was, as this Court points out, in net profits from *production and operation*. If then Shell refused to account monthly to respondent, as required in the contract, and respondent thereupon sued Shell for an accounting, the State court would, pursuant to the *Schiffman* case, decree that the accounting be made. Could this Court deny the effect of such a decree? Because of this controlling effect of the *Schiffman* case, it was quoted from in oral argument at length. May we quote again:

(P. 1082 [Pac.]):

> "By said instruments the Monrovia Oil Company assigned to plaintiff stated percentages of the proceeds to be 'derived and received * * * from the sale or other disposal of sixty-six and two-thirds (66-2/3) per cent of net production' of the well which should remain after payment of expenses."

(P. 1083):

> "Defendant's further contention is that although the participating oil agreements are not the certifi-

cates of beneficial interest provided for by the trust, and plaintiff's rights are measured by the participating agreements alone, nevertheless said agreements created only the personal obligation of the Monrovia Oil Company, and did not give plaintiff any interest in oil produced after the Monrovia Company had assigned the sublease. We are in accord with the judgment of the trial court rejecting both these contentions."

(P. 1088):

"We are of the view that whether or not the royalty assignments in this case transferred to the holders thereof an interest in the leasehold, that is, in the profit *a prendre* to produce oil, in any event they vested in the holders a right to share in the proceeds of oil produced during the continuance of the lease by an assignee of the lease with notice."

(P. 1088):

"The rights of the holders of royalty assignments to an interest in the proceeds of oil produced by an assignee of the leasehold should not depend on whether the assignment is of a percentage of the oil 'to be produced, saved, and sold,' as in *Western Oil etc. Co. v. Venago Oil Corp., supra,* or is of a percentage of the net proceeds as in the instant case."

(P. 1089):

"It is certainly not within the contemplation of the royalty holder that in addition to the other risks involved, the lessee may at any time terminate the royalty holder's interest by assigning the lease, and leave the royalty holder remediless or with a claim for a share of the price received by the lessee for the

transfer of the leasehold, or a claim for monetary damages."

(P. 1089):

"Where royalty assignments are made by a lessee, the holders thereof have an interest in oil produced by an assignee of the leasehold covering the land from which the oil is to be produced who acquires the leasehold with notice, or in the proceeds thereof."

It may be observed that the next to the last passage quoted states the reason for the rule, the very point made above that the right to a share in net profits from production and operation would otherwise be a nullity. In addition to the *Schiffman* case, respondent cited *Akin v. Marshall Oil Co.*, 188 Pa. 602, 41 Atl. 748, which went so far as to hold (at p. 750) that where a lessee, as here, transfers the properties with a provision for payment to him of a share of the net profits, such provision is a covenant running with the land. No cases to the contrary were shown by the Commissioner here. Nor does this Court in its opinion herein cite any cases showing that by the contract here involved respondent reserved no equitable interest in the *res*. Perhaps, indeed, it does not deny that respondent reserved such an interest. It merely says (in No. 406, cited here on this point): "No trust was declared by which respondent could claim an equitable interest in the *res*." Of course, no trust was declared here *in haec verba;* but it is settled law, as was pointed out in oral argument, that a trust may be implied from reservations or other provisions in a contract. Says *Corpus Juris*, 65 C. J. 277, citing cases from many jurisdictions:

> "An express trust may be created, not only by deed or conveyance which expressly provides that the property conveyed shall be held for the beneficiary, but also by a deed or other transfer containing conditions, reservations, or other provisions sufficiently indicating an intention that the title shall be held in trust * * *."

Surely this Court does not mean that even though the taxpayer has an equitable interest in the *res*, it is not entitled to percentage depletion because the interest was not reserved by a declaration of trust *in haec verba*. This Court has said that taxation is eminently practical. *Tyler v. United States*, 281 U. S. 487, 503; *Burnet v. Sanford & Brooks Co.*, 282 U. S. 359, 365. It has also said that taxation is not concerned with the refinements of title. *Corliss v. Bowers*, 281 U. S. 376. *A fortiori*, where the right created is necessarily an equitable interest in the *res*, not only because the law of the situs says that it is, but because by the very nature of the right itself it can otherwise have no sense at all, it cannot be brushed aside merely because the contract did not say, with respect to such right, "the parties hereby declare this to be a trust." If this Court is concerned by what the provision granting such right to the taxpayer did or did not "purport" (No. 406) to do, then surely it did not purport to be a sham and a deceit—a grant to one party to the contract of a right, subject to a power in the other party at will to destroy it.

The same conflict in the opinion of this Court appears therein in an additional aspect. The transaction, it says, was an "absolute sale." "The aggregate sum of $2,-

000,000," it says, "was paid as an agreed purchase price." The date of the transaction is given as October 3, 1927. The taxable years involved, however, are 1928 and 1929. If the "absolute sale," for an "agreed purchase price" of $2,000,000, took place in 1927, then on what theory is any part of such agreed purchase price income in 1928 and 1929? Or stated inversely, if the payments of $400,000 each in 1928 and 1929 were income in those years at all, on what theory were they income from a sale which took place in 1927? Although respondent was, in fact, on the accrual basis (R. 19-20), the result would be the same if they were on the cash basis. Only the installment basis permits treating the amounts received on a sale as income in the years received regardless of the year of sale—*Treasury Regulations* 74, Art. 354; and the deduction here of the entire cost in 1927, shown in the opinion, negatives any election of the installment basis, even if such election were possible here. On what theory then, if the amounts received in 1928 and 1929 were income in those years at all, were they income from an "absolute sale" which took place in 1927? If not income from a sale, then what were they income from if not from the property?

The inconsistency is obvious enough with respect to the so-called cash payments involved here; it is glaring when the payments to be made out of net profits are considered. An "absolute sale" is made in 1927. In May, 1938, say, a payment is received out of the net profits of production and operation during the preceding month. Such payment could not possibly be income before 1938; yet this Court says such income is derived from the sale com-

pletely made in 1927. And if not from the sale, what from if not from the property? This is but another aspect of the conflict in the opinion of this Court considered above. There can be no escape from the conclusion that an "absolute sale" of properties, and a provision for payment to the vendor of a share of the net profits of *production and operation,* are in necessary conflict with each other.

On the face of this Court's own opinion, we submit, eliminating the clear conflict therein shown above, respondent did reserve an equitable interest in the *res;* so that the opinion itself supports respondent instead of the Government.

II.

This Court Has Erroneously Assumed that the Net Income is Something Wholly Distinct From the Gross Income, Instead of, as It Is, a Part of the Gross Income Itself.

We submit the following truths to be self-evident:

1. Net profits, or net income, is that part of the gross income left after deducting expenses.

2. The gross income therefore includes the net income, and the net income is part of the gross income.

3. One who owns a share in the net income therefore owns *pro tanto* a share in the gross income.

The point made by this Court in *Helvering v. O'Donnell,* No. 406, that, "if there were no profits, nothing would be payable to him," is wholly irrelevant, since if there were no net profits no one would be entitled to per-

centage depletion. The statute expressly provides that the allowance "shall not exceed 50 per centum of the net income."[2] Therefore, if there is no net income, there is no allowance of percentage depletion to any one, no matter how great the gross income may be. If it be assumed that there is no net income, it might as well also be assumed that there is no gross income, as far as percentage depletion is concerned.

We submit that this Court erroneously assumed that the net income is something wholly distinct from the gross income, instead of, as it is, a part of the gross income itself.

DISCUSSION OF REASON FOR GRANTING A REHEARING OR AMENDMENT OF JUDGMENT.

I.

The Decision of This Court is Based Upon a Mixed Issue of Law and Fact Not Raised at All Before the Board, Nor Before the Court Below, Nor Fairly Raised in the Government's Petition or Brief Filed in This Court.

The keystone of this Court's opinion herein is that respondent did not retain an equitable interest in the *res*. This is obviously a mixed question of law and fact. That this issue was not presented to or considered by the Board is shown by the fact that on the basis of this issue

---

[2]*Revenue Act of 1928*, C. 852, 45 Stat. 791, Sec. 114 (b) (3); set forth in full in Brief for Respondent, p. 30.

this Court reversed the Board in No. 406 and affirmed the Board here. Nor was it presented in any form before the Court below. Nor even before this Court was it fairly raised, although perhaps it lurked beneath the lines in the Government's brief. Respondent therefore submits that it would be unfair to it to conclude this cause without rehearing.

Respondent submits also that on this ground it should at least be granted leave to apply to the Board for opportunity to establish additional facts which would affect the result. Had the issue as to whether respondent reserved an equitable interest in the properties been raised before the Board respondent might have shown, for example, the interpretation placed upon the contract involved by the parties thereto, and by subsequent transferees of the leases transferred under the contract. It might have shown that such subsequent transferees recognized the equitable interest of respondent in the properties, and acted upon it, and accounted and still account monthly to respondent. It might have shown, moreover, that this accounting is the monthly accounting required by paragraph 9 of the contract (R. 59), so that this Court in its reference to paragraph 9 as only "relating to abandonment of the purchase and reconveyance" may have seriously misstated the provisions of the contract. Respondent might also have shown that even after the time for abandonment of the contract had passed, such subsequent transferees sought and secured respondent's approval of changes in the leases transferred to them.

Such interpretation by the parties affected by the contract was considered by this Court in *Thomas v. Perkins,*

301 U. S. 655, 659. Moreover, no matter how the language used may be understood, it can hardly be doubted that the view now expressed by this Court with respect to percentage depletion is a decided limitation on the "economic interest" doctrine announced in *Palmer v. Bender, supra.* Had the present view of this Court been known at the time this proceeding was before the Board, much additional evidence, in line with that indicated above, might have been introduced. That respondent should be granted leave to apply to the Board for opportunity to introduce such evidence, and such other evidence as might be pertinent, is shown in *Helvering v. Gowran,* 302 U. S. ..... (decided December 6, 1937), wherein this Court stated:

> "If the Court of Appeals had accepted the theory, it would have been open to the taxpayer to urge, in view of the new issue presented that he should have the opportunity to establish before the Board additional facts which would affect the result. As we accept the new theory, leave is granted to apply to the lower court for that purpose."

Conclusion

For the reasons stated above it is respectfully submitted that a rehearing should be granted, or at least that the judgment of this Court herein should be amended so as to grant respondent leave to apply to the Board for opportunity to establish additional facts which would affect the result.

GEORGE T. ALTMAN,
Attorney for Respondent.

CERTIFICATE

I, GEORGE T. ALTMAN, attorney for respondent in the within entitled action, hereby certify that the foregoing Petition is, in my judgment, well founded and is not interposed for delay.

GEORGE T. ALTMAN,
Attorney for Respondent.

P. 1.

SUPREME COURT OF THE UNITED STATES.

No. 446.—October Term, 1937.

Guy T. Helvering, Commissioner of Internal Revenue, Petitioner, *vs.* Elbe Oil Land Development Company.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

[March 7, 1938.]

Mr. Chief Justice Hughes delivered the opinion of the Court.

The question is whether certain payments received by respondent in the years 1928 and 1929 constituted "gross income from the property", within the meaning of that phrase as used in relation to oil and gas wells in Section 114 (b) (3) of the Revenue Act of 1928, so as to entitle respondent to the prescribed depletion allowance. The Circuit Court of Appeals, reversing the decision of the Board of Tax Appeals (34 B. T. A. 333), sustained ~~petitioner's~~ respondent's claim. 91 F. (2d) 127. Certiorari was granted (— U. S. —) because of an asserted conflict with the decision of the Circuit Court of Appeals for the Fifth Circuit in *Commissioner* v. *Fleming*, 82 F. (2d) 324.

Respondent is a California corporation which acquired certain properties consisting of oil and gas prospecting permits, drilling agreements, leases and equipment. Development work resulted in the discovery of oil. On October 3, 1927, respondent conveyed all its right, title and interest in the described properties to the Honolulu Consolidated Oil Company. The latter agreed to pay to respondent $350,000 upon the execution of the agreement and, if the Honolulu Company should not elect to abandon the purchase (in accordance with one of the stipulations), the additional sums of $400,000 in each of the years 1928, 1929 and 1930, and the further sum of $450,000 in 1931. After the time when the Honolulu Company had been fully reimbursed as provided in the agreement for all its expenditures in the acquisition, development and operation of the properties, respondent was to receive monthly one-third of the net profits resulting from the production and opera-

tion. After careful stipulations with respect to such reimbursement and the computation of net profits, the agreement provided:

"Anything in this agreement contained to the contrary notwithstanding, it is the intention of the parties to this agreement that the full ownership, possession and control of all the properties, the subject of this agreement, and of all of the personal property acquired and/or used on and in connection with the operation and development of the properties, the subject of this agreement, shall be vested in Honolulu, and Elbe shall have no interest in or to said properties or in or to any personal property used on or in connection with the operation or development of the said properties or in or to the salvage value of any thereof, except as provided by paragraph 9" [relating to abandonment of the purchase and reconveyance].

The first payment of $350,000 was received by respondent in 1927 and being greater than the cost of all the properties transferred, respondent reported as taxable income the difference between that cost basis and the amount received. In its income tax returns for the years 1928 and 1929, respondent reported the payments of $400,000 received in each of the years and claimed 27½ per cent. thereof as an allowance for depletion. This is the claim which has been sustained below.

We agree with the conclusion of the Board of Tax Appeals that the contract between the respondent and the Honolulu Company provided for an absolute sale of all the properties in question, including all the oil and gas in place, and that respondent did not retain any interest or investment therein. The aggregate sum of $2,000,000 was paid as an agreed purchase price to which was to be added the one-third of the net profits payable on the conditions specified. We are unable to conclude that the provision for this additional payment qualified in any way the effect of the transaction as an absolute sale or was other than a personal covenant of the Honolulu Company. See *Helvering* v. *O'Donnell*, decided this day. In this view, neither the cash payments nor the agreement for a share of subsequent profits constituted an advance royalty, or a "bonus" in the nature of an advance royalty, within the decisions recognizing a right to the depletion allowance with respect to payments of that sort. Such payments are made to the recipient as a return upon his capital investment in the oil or gas in place. See *Burnet* v. *Harmel*, 287 U. S. 103, 111, 112; *Murphy Oil Company* v. *Burnet*, 287 U. S. 299, 302. Payments of the purchase price

which are received upon a sale of oil and gas properties are in a different category. The words "gross income from the property", as used in the statute governing the allowance for depletion, mean gross income received from the operation of the oil and gas wells by one who has a capital investment therein,—not income from the sale of the oil and gas properties themselves. See *Darby-Lynde Company* v. *Alexander,* 51 F. (2d) 56, 59. We conclude that as respondent disposed of the properties, retaining no investment therein, it was not entitled to make the deduction claimed for depletion. *Palmer* v. *Bender,* 287 U. S. 551, 557; *Helvering* v. *Twin Bell Syndicate,* 293 U. S. 312, 321; *Thomas* v. *Perkins,* 301 U. S. 655, 661; *Helvering* v. *Bankline Oil Company, supra; Helvering* v. *O'Donnell, supra.*

The judgment of the Circuit Court of Appeals is reversed and the cause is remanded for further proceedings in conformity with this opinion.

It is so ordered.

Mr. Justice CARDOZO and Mr. Justice REED took no part in the consideration and decision of this case.

A true copy.

Test:

Clerk, Supreme Court, U. S.